

**DESCRIPTION OF CHAIRMAN'S MARK  
FOR REVENUE RECONCILIATION PROPOSALS**

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## **DESCRIPTION OF REVENUE RECONCILIATION PROPOSALS**

### **B. Tax Credit for Adoption Expenses; Exclusion for Certain Adoption Expenses**

#### **Present Law**

Present law does not provide a tax credit for adoption expenses. Also, present law does not provide an exclusion from gross income for employer-provided adoption assistance. The Federal Adoption Assistance program (a Federal outlay program) provides financial assistance for the adoption of certain special needs children. In general, a special needs child is defined as a child who (1) according to a State determination, could not or should not be returned to the home of the natural parents and (2) on account of a specific factor or condition (such as ethnic background, age, membership in a minority or sibling group, medical condition, or physical, mental or emotional handicap), could not reasonably be expected to be adopted unless adoption assistance is provided. Specifically, the program provides assistance for adoption expenses for those special needs children receiving Federally assisted adoption assistance payments as well as special needs children in private and State-funded programs. The maximum Federal reimbursement is \$1,000 per special needs child. Reimbursable expenses include those nonrecurring costs directly associated with the adoption process such as legal costs, social service review, and transportation costs.

#### **Description of Proposal**

##### **Tax credit**

The proposal would provide taxpayers with a maximum credit against income tax liability of \$5,000 per child for qualified adoption expenses paid or incurred by the taxpayer. Any unused adoption credit could be carried forward by the taxpayer for up to five years. Qualified adoption expenses would be reasonable and necessary adoption fees, court costs, attorneys' fees and other expenses that are directly related to the legal and final adoption of an eligible child. An eligible child would be an individual (1) who has not attained age 18 as of the time of the adoption, or (2) who is physically or mentally incapable of caring for himself or herself. No credit would be allowed for expenses incurred (1) in violation of State or Federal law, (2) in carrying out any surrogate parenting arrangement, or (3) in connection with the adoption of a child of the taxpayer's spouse. The credit would be phased out ratably for taxpayers with taxable income above \$60,000, and would be fully phased out at \$100,000 of taxable income.

The \$5,000 limit would be a per child limit, not an annual limitation. For example, if a

deduction. Also the credit would not allowed for any expenses for which a grant is received under any Federal, State, or local program.

The proposal would provide that individuals who are married at the end of the taxable year must file a joint return to receive the credit unless they lived apart from each other for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for the child for more than one-half of the taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year. Further, the proposal would provide that an individual legally separated from his spouse under a decree of divorce or separate maintenance would not considered married for purposes of this provision.

### **Exclusion from income**

The proposal would provide a maximum \$5,000 exclusion from the gross income of an employee for amounts paid by the employer. The \$5,000 limit would be a per child limit, not an annual limitation. These amounts must be in connection with an adoption of an eligible child (as described above) by an employee if such amounts are furnished pursuant to an adoption assistance program. An adoption reimbursement program operated under section 1052 of title 10 of the U.S. Code (relating to the armed forces) or section 514 of title 14 of the U.S. Code (relating to members of the Coast Guard) would be treated as an adoption assistance program for these purposes. An adoption assistance program would be a nondiscriminatory plan of an employer under which the employer provides employees with adoption assistance. Also, not more than 5 percent of the benefits under the program for any year could benefit more than 5 percent owners of the employee or their spouses or dependents. An adoption assistance program would not have to be funded. Adoption assistance would be a qualified benefit under a cafeteria plan. The exclusion would be phased out ratably for taxpayers with taxable income (determined without regard to the exclusion) above \$60,000 and would be fully phased out at \$100,000 of taxable income (determined without regard to the exclusion). No credit would be allowed for adoption expenses paid as reimbursed under an adoption assistance program.

### **Effective Date**

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

## **C. Marriage Penalty Relief: Increase in Standard Deduction for Joint Returns**

### **Present Law**

#### **Marriage penalty**

A married couple generally is treated as one tax unit that must pay tax on the unit's total taxable income. Although married couples may elect to file separate returns, the rate schedules and provisions are structured so that filing separate returns usually results in a higher tax than filing joint returns. Other rate schedules apply to single persons and to single heads of household.

A "marriage penalty" exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A "marriage bonus" exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose earnings are split more evenly than 70-30 suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus.

Under present law, the size of the standard deduction and the tax bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and tax bracket breakpoints for single filers are roughly 60 percent of those for joint filers. The standard deduction and tax bracket breakpoints for head of household filers are about 83 percent of those for joint filers. With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals. Furthermore, because of the way the tax bracket breakpoints are structured, as joint filers they may have some of their taxable income pushed into a higher marginal tax bracket than when they were not married.

The rate changes in the Revenue Reconciliation Act of 1993 exacerbated the existing marriage penalty because the new tax bracket breakpoints did not provide the customary ratios across filing statuses. For the new 36-percent tax bracket, the breakpoint for single filers and for head of household filers are 82 percent and 91 percent, respectively, of the breakpoint for joint filers. For the 39.6-percent tax bracket, the tax bracket breakpoint is \$250,000 regardless of filing status.



## **Standard deduction**

Taxpayers who do not itemize deductions may choose the standard deduction. The size of the standard deduction varies according to filing status and is indexed for inflation. For 1995, the size of the standard deduction is as follows:

<b><u>Filing status</u></b>	<b><u>Standard deduction</u></b>
Married, joint return .....	\$6,550
Head of household return .....	5,750
Single return .....	3,900
Married, separate return .....	3,275

For 1996, the size of the standard deduction is projected to be as follows:

<b><u>Filing status</u></b>	<b><u>Standard deduction</u></b>
Married, joint return .....	\$6,700
Head of household return .....	5,900
Single return .....	4,000
Married, separate return .....	3,350

Taxpayers may claim an additional standard deduction if they are blind or aged 65 or older. For 1995, the amount of the additional standard deduction is \$750 (\$900 if the taxpayer is unmarried and not a surviving spouse). These amounts are indexed for inflation.

The total amount of standard deductions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income.

### **Description of Proposal**

The proposal would increase the standard deduction for married taxpayers filing a joint return according to the following schedule:

**For taxable years  
beginning in  
calendar year--**

**The standard deduction  
would be--**

1996 .....	\$6,800
1997 .....	7,150
1998 .....	7,500
1999 .....	7,950
2000 .....	8,200
2001 .....	8,600
2002 .....	9,100
2003 .....	9,500
2004 .....	9,950
2005 .....	10,800

For calendar years after 2005, the amount would be indexed for inflation.

Providing the marriage penalty relief through an increase in the standard deduction would target the relief to moderate-income taxpayers, who are less likely to itemize deductions.

**Effective Date**

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

## **D. Credit for Interest on Student Loans**

### **Present Law**

The Tax Reform Act of 1986 repealed the deduction for personal interest. Student loan interest is generally treated as personal interest and thus is not allowable as an itemized deduction from income. There is no tax credit allowed for student loan interest paid by a taxpayer.

### **Description of Proposal**

#### **In general**

The proposal would allow individuals who have paid interest on qualified education loans a nonrefundable credit against regular tax liability generally equal to 20 percent of such interest. The maximum credit allowed would be \$500 (\$1,000 in the case of a taxpayer paying interest on loans for two or more students). Unused amounts of credit could not be carried forward or backward to other taxable years.

A qualified education loan generally would be any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer or the taxpayer's spouse or dependents in attending higher education institutions and certain area vocational education schools (i.e., eligible educational institutions defined in Code section 135(c)(3)). Indebtedness incurred by a student from borrowing from a related party would not be treated as a qualified education loan. The qualified higher education expenses would have to be paid while the individual was at least a half-time student. Indebtedness that is used to refinance any indebtedness described in the previous sentence would also be treated as a qualified education loan. Qualified higher education expenses would be defined as the student's cost of attendance (generally, tuition, fees, room and board, and related expenses). At the time the expenses are incurred, the student would have to be the taxpayer or the taxpayer's spouse or dependent.

#### **Income phaseout range for credit**

The credit would be phased out ratably over the following modified adjusted gross income (AGI) ranges: joint filers (\$60,000-\$75,000) and unmarried individuals (\$40,000-\$55,000). The beginning of the phaseout ranges (but not the size of the phaseout range) would be indexed for inflation for taxable years beginning after 1996. Modified AGI would be defined as the taxpayer's AGI (1) increased by the amount otherwise excluded from gross income under Code sections 135, 911, 931, or 933 (relating to educational savings bonds and to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively) and (2) calculated after the inclusion of Social Security benefits in income, the deduction for individual retirement losses, and the limitation on passive losses.

### **Credit claimed for interest on borrowing for expenses of taxpayer or spouse**

In the case of qualified education loans used to pay the qualified higher education expenses of the taxpayer or the taxpayer's spouse, the credit would be allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. For purposes of counting the 60 months, any qualified education loan and all refinancing (that is treated a qualified education loan) of such loan would be treated as a single loan.

### **Credit claimed for interest on borrowing for expenses of taxpayer's dependent**

In the case of qualified education loans used to pay the qualified higher education expenses of an individual other than the taxpayer or the taxpayer's spouse, no credit would be allowed unless the individual is claimed as a dependent of the taxpayer for that taxable year and the individual is at least a half-time student during that taxable year.

### **Limitations on claiming credit**

No credit would be allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year beginning in the calendar year in which such individual's taxable year begins. No credit would be allowed for interest on any amount of education loan indebtedness for which a deduction is claimed under any other provision.

Couples who are married at the end of the taxable year would have to file a joint return to claim the credit unless they lived apart for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for a dependent child for more than one-half of the taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year. An individual legally separated from his spouse under a decree of divorce or separate maintenance would not considered married for purposes of this provision.

### **Information reporting on student loan interest**

Any person in a trade or business or any governmental agency who receives \$600 or more in qualified education loan interest from an individual during a calendar year would be required to file an information report on such interest to the IRS and to the payor. In the case of interest received by any person on behalf of another person, generally only the first person receiving the interest would be required to file the information reports.

### **Effective Date**

The proposal would be effective for payments of interest due after December 31, 1995, but, in the case of qualified education loans used to pay the qualified higher education expenses of the taxpayer or the taxpayer's spouse, only if the 60-month period has not expired.

## II. INCREASE SAVINGS AND INVESTMENT

### A. Provisions Relating to Individual Retirement Arrangements

#### Present Law

##### In general

Under certain circumstances, an individual is allowed a deduction for contributions (within limits) to an individual retirement account or an individual retirement annuity (an "IRA"). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. No deduction is permitted with respect to IRA contributions made after an individual attains age 70-1/2.

##### Deductible IRA contributions

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of \$2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). The maximum IRA deduction limit is increased to \$2,250 if the individual is married, files a joint return, and has a spouse that has no compensation (or elects to be treated as having no compensation). The \$2,250 contribution may be allocated in any manner between IRAs for each spouse, as long as no more than \$2,000 is contributed for either spouse. A contribution to an IRA is treated as made for a taxable year if made by April 15 of the following year.

A single individual is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income ("AGI") of less than \$25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined AGI of less than \$40,000.

If a single taxpayer or either spouse (in the case of a married couple) is an active participant in an employer-sponsored retirement plan, the maximum IRA deduction is phased out over certain AGI levels. For single taxpayers, the maximum IRA deduction is phased out between \$25,000 and \$35,000 of AGI. For married taxpayers, the maximum deduction is phased out between \$40,000 and \$50,000 of AGI. In the case of a married taxpayer filing a separate return, the deduction is phased out between \$0 and \$10,000 of AGI.

##### Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent they are not permitted to make deductible contributions. An individual may also elect to make nondeductible

contributions in lieu of deductible contributions. Thus, any individual may make nondeductible contributions up to the excess of (1) the lesser of \$2,000 or 100 percent of compensation over (2) the IRA deduction claimed by the individual. An individual making nondeductible contributions is required to report the amount of such contributions on his or her tax return. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions are not subject to income tax until withdrawn.

### **Taxation of withdrawals**

Amounts withdrawn from IRAs (other than amounts that represent nondeductible contributions) are taxable.

To discourage IRA withdrawals for nonretirement purposes, IRA withdrawals before age 59-1/2, death, or disability are generally subject to an additional 10-percent tax. The 10-percent additional tax does not apply to withdrawals that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the individual or the joint lives (or joint life expectancies) of the individual and the individual's designated beneficiary.

### **Description of Proposal**

#### **In general**

The proposal would phase up the income limits on the deductibility of traditional IRA contributions and modify the definition of active participant. The proposal would index the \$2,000 limit on deductible IRA contributions for inflation. In addition, the proposal would permit nondeductible contributions to a new IRA Plus account. The limits on contributions to traditional IRAs and IRA Plus accounts would be coordinated, so that no more than \$2,000 could be contributed per year to an individual's IRAs.

In general, an IRA Plus would be subject to the same rules as IRAs. However, withdrawals from an IRA Plus would not be includible in income (or subject to the 10-percent early withdrawal tax) if attributable to contributions that had been held in the IRA Plus account for at least 5 years and are either (1) made after the individual attains age 59-1/2, or (2) made for a special purpose or on account of death or disability or in the form of an annuity. Other withdrawals would be taxable (to the extent of earnings on contributions).

The proposal would allow penalty-free withdrawals from deductible IRAs to the extent used for certain special purposes. Special purposes would be the purchase of a first home (up to \$10,000), certain education expenses, catastrophic medical expenses, and withdrawals by individuals who have received unemployment compensation for at least 12 weeks.

## **Expansion of deductible IRAs**

The proposal would provide that a person is not considered an active participant for purposes of the IRA rules merely because his or her spouse is an active participant in an employer-sponsored retirement plan.

Beginning in 1996, for single individuals, the proposal would phase up the income limits on deductible IRA contributions in \$5,000 increments until the phaseout range is \$85,000 to \$95,000 (in 2007). Also beginning in 1996, for married couples, the deduction would be phased out over a \$20,000 income range (rather than \$10,000) and the phaseout range would be increased in \$5,000 increments until the phaseout range is \$100,000 to \$120,000 (in 2007). After these new ranges are reached, the income limits would be indexed for inflation in \$5,000 increments.

Thus, under the proposal, the phaseout ranges would be as follows:

<b><u>Year</u></b>	<b><u>Singles</u></b>	<b><u>Married Couples</u></b>
1996	\$30,000 - \$40,000	\$ 45,000 - \$ 65,000
1997	\$35,000 - \$45,000	\$ 50,000 - \$ 70,000
1998	\$40,000 - \$50,000	\$ 55,000 - \$ 75,000
1999	\$45,000 - \$55,000	\$ 60,000 - \$ 80,000
2000	\$50,000 - \$60,000	\$ 65,000 - \$ 85,000
2001	\$55,000 - \$65,000	\$ 70,000 - \$ 90,000
2002	\$60,000 - \$70,000	\$ 75,000 - \$ 95,000
2003	\$65,000 - \$75,000	\$ 80,000 - \$100,000
2004	\$70,000 - \$80,000	\$ 85,000 - \$105,000
2005	\$75,000 - \$85,000	\$ 90,000 - \$110,000
2006	\$80,000 - \$90,000	\$ 95,000 - \$115,000
2007	\$85,000 - \$95,000	\$100,000 - \$120,000
2008 and later	---income thresholds indexed for inflation in \$5,000 increments---	

## **Spousal IRAs**

The proposal would permit annual contributions of up to \$2,000 for each spouse in a married couple.

## **Inflation adjustment for IRA deduction limit**

Under the proposal, the \$2,000 limit on contributions that could be made to an IRA would be indexed for inflation in \$500 increments.



## **IRA investments in coins and metals**

The proposal would permit IRAs to acquire certain coins or bullion, as long as they are in the physical possession of the IRA trustee.

## **IRA Plus accounts**

### **In general**

The proposal would replace present-law nondeductible IRAs with new IRA Plus accounts to which individuals could make nondeductible contributions. Generally, IRA Plus accounts would be subject to the same rules applicable to deductible IRAs. However, a number of special rules would apply.

### **Contributions**

Contributions to an IRA Plus would be nondeductible. The amount of nondeductible contributions to an IRA Plus that could be made for any taxable year would be coordinated with the limits for deductible IRAs, so that the maximum permitted contribution to an IRA Plus would be reduced by any deductible IRA contribution for the year.

### **Taxation of distributions**

The taxation of withdrawals from an IRA Plus would depend on how long the contributions had been in the IRA Plus, the age of the individual, and the purpose of the withdrawal.<sup>1</sup> Withdrawals of amounts attributable to contributions that have been in the IRA Plus for less than 5 years would be includible in income (to the extent of earnings). The 10-percent early withdrawal tax would also apply to the amount includible unless the distribution is on account of death or disability or is in the form of an annuity. Withdrawals made after 5 years and before the individual is age 59-1/2 would be excludable from income (and not subject to the 10-percent tax) if the withdrawal is made for a special purpose, on account of death or disability, or in the form of an annuity; otherwise, such withdrawals would be includible in income (to the extent of earnings) and subject to the 10-percent tax (on earnings). Withdrawals after 5 years and after age 59-1/2 would not be includible in income (or subject to the 10-percent tax), regardless of the purpose of the withdrawal.

In determining whether amounts are includible in income under the 5-year rule, distributions would be treated as having been made first from the earliest contributions (and earnings attributable to such contributions) remaining in the account at the time of distribution

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<sup>1</sup> In some cases, the minimum required distribution rules may require distributions from an IRA Plus to begin before the expiration of the 5-year holding period. The 10-percent tax would not apply to such minimum required distributions.

and then from other contributions (and earnings) in the order made. For purposes of this rule, all contributions for a taxable year would be treated as made on January 1 of that year. Earnings would be allocated to contributions under rules to be prescribed by the Secretary.

### Rollovers

Tax-free rollovers from an IRA Plus to another IRA Plus would be permitted. For purposes of the 5-year rule, the IRA Plus to which amounts are rolled over would be treated as having held the amounts during any period during which such contributions were held in the IRA Plus to which the contributions were first made.

The proposal would permit amounts withdrawn from present-law IRAs to be rolled over into an IRA Plus. The amount rolled over would be includible in gross income in the year the withdrawal was made, except that amounts rolled over to an IRA Plus before January 1, 1998, would be includible in income ratably over a 4-year period. The 10-percent early withdrawal tax would not apply to amounts rolled over from an IRA to an IRA Plus.

### Special purpose withdrawals

#### In general

As described above, withdrawals from an IRA Plus after 5 years and before age 59-1/2 would be excludable from income (and not subject to the 10-percent early withdrawal tax) if the distribution is for a special purpose. In addition, the proposal would provide exceptions to the early withdrawal tax in the case of special purpose distributions from deductible IRAs. In general, special purposes would be (1) qualified first-time homebuyer distributions that do not exceed \$10,000, (2) qualified higher education distributions, (3) distributions used for extraordinary medical expenses, or (4) distributions made to certain unemployed individuals.

#### Withdrawals by first-time homebuyers

Under the proposal, qualified first-time homebuyer distributions would be withdrawals of up to \$10,000 during the individual's lifetime that are used within 60 days to pay costs (including reasonable settlement, financing, or other closing costs) of acquiring, constructing, or reconstructing the principal residence of a first-time homebuyer who is the taxpayer, taxpayer's spouse, or a child, grandchild, or ancestor of the individual or individual's spouse. A first-time homebuyer would be an individual who has not had an ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which the withdrawal relates. The proposal would require that the spouse of the individual also meet this requirement as of the date the contract is entered into or construction commences. The date of acquisition would be the date the individual enters into a binding contract to purchase a principal residence or begins construction or reconstruction of such a residence. Principal residence would

be defined as under the provisions relating to the rollover of gain on the sale of a principal residence.

Under the proposal, any amount withdrawn for the purchase of a principal residence would be required to be used within 60 days of the date of withdrawal. The 10-percent additional income tax on early withdrawals would be imposed with respect to any amount not so used. If the 60-day rule could not be satisfied due to a delay in the acquisition of the residence, the taxpayer would be able to recontribute all or part of the amount withdrawn to the IRA prior to the end of the 60-day period without adverse tax consequences. Any amount recontributed would be treated as a rollover contribution without regard to the limitations on the frequency of IRA-to-IRA rollovers.

#### Withdrawals for education expenses

Qualified higher education expenses would be defined as tuition, fees, books, supplies, and equipment required for courses at an eligible educational institution. Amounts withdrawn would be available for use for the education of the individual or the individual's spouse, or a child, grandchild, or ancestor of the individual or the individual's spouse.

The amount that could be considered qualified higher education expenses would be reduced by any amount that is excludable from the taxable income of the taxpayer under the provisions relating to education savings bonds.

#### Financially devastating medical expenses

Withdrawals for the medical expenses of the individual, his or her spouse or dependents, and any child, grandchild, or ancestor of the individual or the individual's spouse, whether or not a dependent of the individual for income tax purposes, would be a special purpose withdrawal to the extent such medical expenses exceed 7.5 percent of adjusted gross income.

#### Distributions to unemployed individuals

Withdrawals by an individual who has received unemployment compensation for at least 12 consecutive weeks under any Federal or State unemployment compensation law would be a special purpose distribution.

### **Effective Date**

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

## **B. Establish SIMPLE Retirement Plans**

### **Present Law**

Present law does not contain rules relating to SIMPLE retirement plans. However, present law does provide a number of ways in which individuals can save for retirement on a tax-favored basis. These include employer-sponsored retirement plans that meet the requirements of the Internal Revenue Code (a "qualified plan") and individual retirement arrangements ("IRAs"). Employees can earn significant retirement benefits under employer-sponsored retirement plans. However, in order to receive tax-favored treatment, such plans must comply with a variety of rules, including complex nondiscrimination and administrative rules (including top-heavy rules). Such plans are also subject to requirements under the labor law provisions of the Employee Retirement Income Security Act of 1974 ("ERISA").

IRAs are not subject to the same rules as qualified plans, but the amount that can be contributed in any year is significantly less. The maximum deductible IRA contribution for a year is limited to \$2,000.

Distributions from IRAs and employer-sponsored retirement plans are generally taxable when made. In addition, distributions prior to age 59-1/2 generally are subject to an additional 10-percent early withdrawal tax.

Under one type of qualified plan, employees can elect to reduce their taxable compensation and have nontaxable contributions made to the plan. Such contributions are called elective deferrals, and the plans which allow such contributions are called qualified cash or deferred arrangements (or "401(k) plans"). The maximum annual amount of elective deferrals that can be made by an individual is \$9,240 for 1995. This dollar limit is indexed for inflation in \$500 increments. A special nondiscrimination test applies to elective deferrals.

The special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage ("ADP") for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the ADP of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the ADP of all eligible nonhighly compensated employees or such ADP plus 2 percentage points. The ADP for a group of employees is the average of the ratios (calculated separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

An employer may make contributions based on an employee's elective contributions. Such contributions are called matching contributions, and are subject to a special nondiscrimination test similar to the special nondiscrimination test applicable to elective deferrals.

## **Description of Proposal**

### **In general**

The proposal would create a simplified retirement plan for small business called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans could be adopted by employers with 100 or fewer employees who do not maintain another employer-sponsored retirement plan. A SIMPLE plan could either be an IRA for each employee or part of a qualified cash or deferred arrangement ("401(k) plan"). If established in IRA form, a SIMPLE plan would not be subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and would not be subject to the labor law provisions of ERISA. In addition, simplified reporting requirements would apply. Within limits, contributions to a SIMPLE plan would not be taxable until withdrawn.

A SIMPLE plan could also be adopted as part of a 401(k) plan. In that case, the plan would not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and would not be subject to the top-heavy rules. The other qualified plan rules would continue to apply.

### **SIMPLE retirement plans in IRA form**

#### **In general**

A SIMPLE retirement plan would allow employees to make elective contributions to an IRA. Employee contributions would have to be expressed as a percentage of the employee's compensation, and could not exceed \$6,000 per year. The \$6,000 dollar limit would be indexed for inflation in \$500 increments.

The employer generally would be required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. Under a special rule, the employer could elect a lower percentage matching contribution for all employees (but not less than 1 percent of the employee's compensation). In order for the employer to lower the matching percentage, the employer would be required to notify employees of the applicable match. In addition, a lower percentage could not be elected for more than 2 out of any 5 years. No contributions other than employee elective contributions and employer matching contributions could be made to a SIMPLE account.

Only employers who normally employ 100 or fewer employees on any day during the year and who do not currently maintain a qualified plan could establish SIMPLE retirement accounts for their employees.

Each employee of the employer who received at least \$5,000 in compensation from the employer during each of the 2 preceding years and who is reasonably expected to receive at least \$5,000 in compensation during the year would be required to be eligible to participate in the

SIMPLE plan. Nonresident aliens and employees covered under a collective bargaining agreement would not have to be eligible to participate in the SIMPLE plan. Self-employed individuals could participate in a SIMPLE plan.

All contributions to an employee's SIMPLE account would be fully vested.

Rules similar to the spousal consent rules applicable to qualified defined contribution plans would apply to SIMPLE plans.

Distributions generally would be taxed as under the rules relating to IRAs, except that an increased early withdrawal tax would apply to distributions within the first 2 years the SIMPLE is established.

#### Tax treatment of SIMPLE accounts, contributions, and distributions

Contributions to a SIMPLE account generally would be deductible by the employer for the year in which they are made, and would be excludable from the employee's income. SIMPLE accounts, like IRAs would not be subject to tax. Distributions from a SIMPLE retirement account generally would be taxed under the rules applicable to IRAs. Thus, they would be includible in income when withdrawn. Tax-free rollovers could be made from one SIMPLE account to another.

Early withdrawals from a SIMPLE account generally would be subject to the 10-percent early withdrawal tax applicable to IRAs. However, withdrawals of contributions during the 2-year period beginning on the date the employee first participated in the SIMPLE account would be subject to a 25-percent early withdrawal tax (rather than 10 percent). This increased excise tax is intended to encourage employees to keep money in the SIMPLE account for retirement.

#### Administrative requirements

Each eligible employee would be able to elect, within the 60-day period before the beginning of the year, to participate in the SIMPLE plan (i.e., to make elective deferrals), and to modify any previous elections regarding the amount of contributions. An employer would be required to contribute employees' contributions to the employee's SIMPLE account within 30 days after the end of the month to which the contributions relate. Employees would be able to terminate participation in the SIMPLE plan at any time during the year (i.e., to stop making contributions). The plan could provide that an employee that does so could not resume participation until the following year. A plan could permit (but is not required to permit) an individual to make other changes to his or her salary reduction contribution election during the year (e.g., reduce contributions).

No fee could be imposed on the employee with respect to the employee's initial investment decision with respect to any contributions. This rule would not be intended to preclude the imposition of a reasonable fee based on the rate of return on assets held in a SIMPLE account.

### Reporting requirements

Trustee requirements.--The trustee of a SIMPLE account would be required each year to prepare, and provide to the employer maintaining the SIMPLE plan, a summary description containing the following basic information about the plan: the name and address of the employer and the trustee; the requirements for eligibility; the benefits provided under the plan; the time and method of making salary reduction elections; and the procedures for and effects of, withdrawals from the SIMPLE account. At least once a year, the trustee also would be required to furnish an account statement to each individual maintaining a SIMPLE account. In addition, the trustee would be required to an annual file report with the Secretary similar to those required with respect to IRAS. A trustee who fails to provide any of such reports or descriptions would be subject to a penalty of \$50 per day until such failure is corrected, unless the failure is due to reasonable cause.

Employer reports.--The employer maintaining a SIMPLE plan would be required to notify each employee of the employee's opportunity to make salary reduction contributions under the plan immediately before the employee becomes eligible to make such election. This notice would have to include a copy of the summary description prepared by the trustee. An employer who fails to provide such notice would be subject to a penalty of \$50 per day on which such failure continues, unless the failure is due to reasonable cause.

### Definitions

For purposes of the rules relating to SIMPLE plans, compensation would be compensation required to be reported by the employer on Form W-2, plus any elective deferrals of the employee. In the case of a self-employed individual, compensation would mean net earnings from self-employment. "Employer" would include the employer and related employers. Related employers would include trades or businesses under common control (whether incorporated or not), controlled groups of corporations, and affiliated service groups. In addition, the leased employee rules would apply.

For purpose of the rule prohibiting an employer from establishing a SIMPLE plan if they have another qualified plan, an employer would be treated as maintaining a qualified plan if the employer (or a predecessor employer) maintained a qualified plan with respect to which contributions were made, or benefits were accrued, with respect to service in the period beginning with the year the SIMPLE plan became effective and ending with the year for which the determination is being made. In addition, a qualified plan of the employer would not be permitted to give credit for any service (other than vesting or eligibility purposes) during a year for which the employee was eligible to participate in a SIMPLE plan. A qualified plan would include a

qualified retirement plan, a qualified annuity plan, a governmental plan, a tax-sheltered annuity, and a simplified employee pension.

### **SIMPLE 401(k) plans**

Under the proposal, a cash or deferred arrangement (i.e., 401(k) plan), would be deemed to satisfy the special nondiscrimination tests applicable to employee elective deferrals and employer matching contributions if the plan satisfies the contribution requirements applicable to SIMPLE plans. In addition, the plan would not be subject to the top-heavy rules for any year for which the safe harbor is satisfied. The plan would be subject to the other qualified plan rules.

The safe harbor would be satisfied if, for the year the employer does not maintain another qualified plan and (1) employee's elective deferrals are limited to no more than \$6,000, (2) the employer matches employees' elective deferrals up to 3 percent of compensation, and (3) no other contributions are made to the arrangement. Contributions under the safe harbor would have to be 100 percent vested. The employer could not reduce the matching percentage below 3 percent of compensation.

In order for the safe harbor to be satisfied, the following SIMPLE administrative requirements would also have to be satisfied: (1) no fee with respect to the employee's initial investment, (2) the employee's right to terminate participation during the year, and (3) the 60-day election period.

### **Effective Date**

The proposal relating to SIMPLE plans would be effective for years beginning after December 31, 1995.



## **C. Capital Gains Provisions**

### **1. 50-percent capital gains deduction for individuals**

#### **Present Law**

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

Prior to the enactment of the Tax Reform Act of 1986, individuals were allowed a deduction equal to 60 percent of net capital gain. The deduction resulted in a maximum effective tax rate of 20 percent on such gains.

Capital losses are generally deductible in full against capital gains. In addition, individuals may deduct capital losses against up to \$3,000 of ordinary income in each year. Capital losses in excess of the amount deductible are carried forward indefinitely. Prior to the Tax Reform Act of 1986, individuals were required to use two dollars of long-term capital loss to offset each dollar of ordinary income.

#### **Description of Proposal**

The proposal would allow individuals a deduction equal to 50 percent of net capital gain for the taxable year. The proposal would repeal the present-law maximum 28-percent rate. Thus, under the proposal, the effective rate under the regular tax on the net capital gain of an individual in the highest (i.e., 39.6 percent) marginal rate bracket would be 19.8 percent. One-half of the capital gains deduction would be a minimum tax preference.

Collectibles would be excluded from net capital gain. A maximum rate of 28 percent would apply to the net gain from the sale or exchange of collectibles held for more than one year.

The proposal would reinstate the rule in effect prior to the 1986 Tax Reform Act that required two dollars of the long-term capital loss of an individual to offset one dollar of ordinary income. The \$3,000 limitation on the deduction of capital losses against ordinary income would continue to apply.

#### **Effective Date**

The proposal generally would apply to sales and exchanges (and installment payments received) after October 13, 1995.

The capital loss rule would not apply to losses arising in taxable years beginning before January 1, 1996.

## **2. Small business stock**

### **Present Law**

The Revenue Reconciliation Act of 1993 provided individuals a 50-percent exclusion for the sale of certain small business stock acquired at original issue and held for at least five years. One-half of the excluded gain is a minimum tax preference.

The amount of gain eligible for the 50-percent exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) \$10 million.

In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed \$50 million. The corporation also must meet an active trade or business requirement.

### **Description of Proposal**

The taxable portion of the gain from the sale of small business stock would be eligible for the capital gains deduction added by the proposal. Thus, only 25 percent of the gain from a qualified sale of small business stock would be subject to tax. The effective rate under the regular tax on the gain of an individual in the highest (i.e., 39.6 percent) marginal rate bracket would be 9.9 percent.

The proposal would increase the size of an eligible corporation from gross assets of \$50 million to gross assets of \$100 million. The proposal would also repeal the limitation on the amount of gain an individual could exclude with respect to the stock of any corporation.

The proposal would provide that certain working capital must be expended within five years (rather than two years) in order to be treated as used in the active conduct of a trade or business. No limit on the percent of the corporation's assets that are working capital would be imposed.

The proposal would provide that if the corporation establishes a business purpose for a redemption of its stock, that redemption would be disregarded in determining whether other newly issued stock could qualify as eligible stock.

The proposal would allow an individual to roll over gain from the sale or exchange of small business stock otherwise qualifying for the exclusion where the individual uses the proceeds to purchase other qualifying small business stock within 60 days of the sale of the original stock. If the individual sells the replacement stock, the gain attributable to the original stock would be eligible for the small business stock exclusion and the capital gain deduction, and any remaining gain would be eligible for the capital gain deduction if held more than one year and the small business exclusion if held for at least five years. In addition, any gain that otherwise would be recognized from the sale of the replacement stock could be rolled over to other small business stock purchased within 60 days.

#### **Effective Date**

The increase in the size of corporations whose stock is eligible for the exclusion would apply to stock issued after the date of the enactment of the proposal. The remaining provisions would apply to stock issued after August 10, 1993 (the original effective date of the small business stock provision).

### **3. 28-percent corporate alternative tax for capital gains**

#### **Present Law**

Under present law, the net capital gain of a corporation is taxed at the same rate as ordinary income, and subject to tax at graduated rates up to 35 percent. Prior to the Tax Reform Act of 1986, the net capital gain of a corporation was subject to a maximum effective tax rate of 28 percent.

#### **Description of Proposal**

The proposal would provide an alternative tax of 28 percent on the net capital gain of a corporation if that rate is less than the corporation's regular tax rate.

#### **Effective Date**

The proposal generally would apply to sales and exchanges (and installment payments received) after October 13, 1995.

## **D. Alternative Minimum Tax (AMT) Reform**

### **1. Provide relief for depreciation deductions**

#### **Present Law**

##### **Alternative minimum tax, in general**

Present law imposes an alternative minimum tax ("AMT") on an individual or a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The individual minimum tax is imposed at graduated rates of 26 and 28 percent on alternative minimum taxable income in excess of a phased-out exemption amount; the corporate minimum tax is imposed at a rate of 20 percent on alternative minimum taxable income in excess of a phased-out \$40,000 exemption amount. Alternative minimum taxable income ("AMTI") is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

##### **Depreciation under the AMT**

Individuals and corporations must adjust their regular tax depreciation deductions in computing their AMTI. Under the AMT, depreciation on property placed in service after 1986 must be computed by using the class lives prescribed by the alternative depreciation system of section 168(g) and either (1) the straight-line method in the case of property subject to the straight-line method under the regular tax or (2) the 150-percent declining balance method in the case of other property. Under the regular tax, depreciation on such property generally is determined using shorter recovery periods and more accelerated recovery methods. The depreciable lives for some property is the same under both the regular tax and the AMT. For example, automobiles, light general purpose trucks, computers and other qualified technological equipment, and semi-conductor manufacturing equipment have 5-year lives under both the regular tax and the AMT; however, such property has a slower recovery method under the AMT (the 150-percent declining balance method) than it does under the regular tax (the 200-percent declining balance method). Similarly, other property (generally, longer-lived personal property and real property) have the same recovery methods under the regular tax and the AMT, but have longer depreciable lives under the AMT.

In the case of a corporation, in addition to the regular set of adjustments and preferences used in calculating AMTI, there is a second set of adjustments known as the "adjusted current earnings" adjustment. The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings ("ACE") of a corporation exceeds its AMTI

(determined without the ACE adjustment and the alternative tax net operating loss deduction).<sup>2</sup> The determination of ACE generally follows the rules for the determination of corporate earnings and profits. For property placed in service before 1994, depreciation under ACE generally is determined using the straight-line method and the class life determined under the alternative depreciation system.<sup>3</sup> Pursuant to a provision contained in the Omnibus Budget Reconciliation Act of 1993, an ACE depreciation adjustment is not required with respect to property placed in service after 1993.

### **Description of Proposal**

For purposes of the individual and corporate AMTs, the proposal would conform the AMT depreciation method to the regular tax method. Thus, property that is recovered using the 200-percent declining balance method for regular tax purposes (generally, shorter-lived tangible personal property) would use that method under the AMT. The proposal would not change the class lives applicable to property for AMT purposes.

### **Effective Date**

The proposal would be effective for property placed in service after December 31, 1995.

## **2. Allow corporations to take certain minimum tax credits against the minimum tax**

### **Present Law**

As described above, present law imposes an alternative minimum tax ("AMT") on an individual or a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability.

If a taxpayer is subject to the AMT in one year, such amount of tax is allowed as a credit ("AMT credit") in a subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in such subsequent year. If the taxpayer is an individual, the AMT credit is allowed to the extent the taxpayer's AMT liability is a result of adjustments that are timing in nature (e.g., the adjustment for depreciation). The AMT credit has an unlimited carryforward but cannot be carried back.

The various credits allowed under the regular tax generally are not allowed against the AMT. To the extent the orphan drug credit of section 28 or the nonconventional fuels credit of

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<sup>2</sup> If ACE is less than AMTI, the ACE adjustment may reduce AMTI to the extent of prior-year ACE inclusions.

<sup>3</sup> Similar rules apply for purposes of computing corporate earnings and profits under sec. 312(k).

section 29 are not allowed in a taxable year because of this limitation, the amount of credit so disallowed becomes part of the taxpayer's AMT credit. Unlike other credits, unused sections 28 and 29 credits cannot be carried over to other taxable years.

### **Description of Proposal**

The proposal would allow a corporation with certain AMT credits to offset a portion of its tentative minimum tax in excess of its regular tax. The portion so allowed would be the least of: (1) the amount of the taxpayer's AMT credits that are at least five years old; (2) 50 percent of the taxpayer's tentative minimum tax; or (3) the amount by which the taxpayer's tentative minimum tax exceeds its regular tax for the year. A taxpayer would be deemed to use its oldest AMT credits first under both the present-law provision that allows the use of AMT credits and under the proposal. The use of AMT credits under the proposal would not affect the present-law ability of a corporation to generate AMT credits in the year the proposal is used. Likewise, the proposal would not affect the determination of a corporation's alternative minimum tax or its tentative minimum tax (e.g., the 90-percent limitations on the use of net operating losses and foreign tax credits would continue to apply as under present law).

The following examples illustrate the proposal:

**Example 1.**--Assume that calendar year corporation X is liable for a minimum tax of \$1,000 in each of the years 1990 through 1994. Corporation X was not subject to the minimum tax before 1990. In 1995, X's regular tax exceeds its tentative minimum tax ("TMT") by \$200. Under present law, X is allowed to offset its regular tax with an AMT credit of \$200 in 1995. Further assume that in 1996, the TMT of X is \$1,000 and its regular tax is \$400.

Under the proposal, for 1996, X would be allowed to offset its TMT of \$1,000 with an AMT credit of \$500, computed as the least of:

- (1) \$800, i.e., its unused AMT credits from 1990, that are at least five years old;
- (2) \$500, i.e., one-half of its \$1,000 TMT; or
- (3) \$600, i.e., the excess of its \$1,000 TMT over its \$400 regular tax.

**Example 2.**--Assume the same facts as in Example 1, except that X has a regular tax of \$600 in 1996 (rather than \$400). Under the proposal, for 1996, X would be allowed to offset its TMT of \$1,000 with an AMT credit of \$400, computed as the least of:

- (1) \$800, i.e., its unused AMT credits from 1990;
- (2) \$500, i.e., one-half of its \$1,000 TMT; or
- (3) \$400, i.e., the excess of its \$1,000 TMT over its \$600 regular tax.

**Example 3.**--Assume the same facts as in Example 1, except that X's minimum tax liability in each of the years 1990 through 1994 was \$500 (rather than \$1,000 in each year). Under the proposal, for 1996, X would be allowed to offset its TMT of \$1,000 with an AMT credit of \$300, computed as the least of:

- (1) \$300, i.e., the unused AMT credit from 1990;
- (2) \$500, i.e., one-half of its \$1,000 TMT; or
- (3) \$600, i.e., the excess of its \$1,000 TMT over its \$400 regular tax.

**Effective Date**

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

## **E. Establish 15-Year Recovery Period for Retail Motor Fuel Outlet Stores**

### **Present Law**

Under present law, property used in the retail gasoline trade is depreciated under section 168 using a 15-year recovery period and the 150-percent declining balance method. Nonresidential real property (such as a convenience store) is depreciated using a 39-year recovery period and the straight-line method. It is understood that taxpayers generally have taken the position that convenience stores and other structures installed at motor fuel retail outlets have a 15-year recovery period. The IRS, in a position described in a recent Coordinated Issues Paper, generally limits the application of the 15-year recovery period to instances where the structure (1) is 1,400 square feet or less or (2) meets a 50-percent test. The 50-percent test is met if : (1) 50 percent or more of the gross revenues that are generated from the building are derived from petroleum sales and (2) 50 percent or more of the floor space in the building is devoted to petroleum marketing sales.

### **Description of Proposal**

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

### **Effective Date**

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



## **F. Allow Bank Common Trust Funds to Transfer Assets to Regulated Investment Companies Without Taxation**

### **Present Law**

#### **Common trust funds**

A common trust fund is a fund maintained by a bank exclusively for the investment and reinvestment of monies contributed by the bank in its role as a trustee, executor, and other fiduciary capacity.

The common trust fund of a bank is not subject to tax and is not treated as a corporation. Each participant in a common trust fund includes his proportional share of common trust fund income, whether or not the income is distributed.

No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of an interest. Withdrawals from the fund generally are treated as the sale of an interest by the participant.

#### **Regulated investment companies (RICs)**

A RIC also is treated as a conduit for Federal income tax purposes. A RIC gets a deduction for dividend distributions to its shareholders. Present law is unclear as to whether a common trust can transfer its assets to one or more RICs tax-free.

### **Description of Proposal**

In general, the proposal would permit a common trust fund to transfer substantially all of its assets to one or more RICs without gain or loss being recognized. The fund must transfer its assets to the RICs solely in exchange for shares of the RICs, and the fund must then distribute the RIC shares to the fund's participants in exchange for the participant's interests in the fund. In addition, each participant's pro-rata interest in each of the RICs must be substantially the same as was the participant's pro-rata interest in the fund.

The basis of any asset that is received by a RIC will be the basis of the asset in the hands of the fund prior to transfer (increased by the amount of gain recognized by reason of the rule regarding the assumption of liabilities). In addition, the basis of any RIC shares ("converted shares") that are received by a fund participant will be an allocable portion of the participant's basis in the interests exchanged. However, special basis rules will apply to determine gain or loss from RIC shares that are redeemed after the conversion.

The tax-free transfer is not available to a common trust fund with assets that are not diversified except that the diversification test is modified so that Government securities are not to be included as securities of an issuer and are to be included in determining total assets for purposes of the 25- and 50-percent tests.

No inference is intended as to the tax consequences under present law when a common trust fund transfers its assets to one or more RICs.

#### **Effective Date**

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

### **III. HEALTH CARE-RELATED PROVISIONS**

#### **A. Treatment of Long-Term Care Insurance**

##### **Present Law**

##### **In general**

Present law generally does not provide explicit rules relating to the tax treatment of long-term care insurance contracts or long-term care services. Thus, the treatment of long-term care contracts and services is unclear. Present law does provide rules relating to the tax treatment of medical expenses and accident or health insurance.

##### **Deduction for medical expenses**

In determining taxable income for Federal income tax purposes, a taxpayer is allowed an itemized deduction for unreimbursed expenses that are paid by the taxpayer during the taxable year for medical care of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer, to the extent that such expenses exceed 7.5 percent of the adjusted gross income of the taxpayer for such year.

##### **Exclusion for amounts received under accident or health insurance**

Amounts received by a taxpayer under accident or health insurance for personal injuries or sickness generally are excluded from gross income to the extent that the amounts received are not attributable to medical expenses that were allowed as a deduction for a prior taxable year.

##### **Treatment of accident or health plans maintained by employers**

Employer contributions to an accident or health plan that provides compensation (through insurance or otherwise) to an employee for personal injuries or sickness of the employee, the employee's spouse, or a dependent of the employee, are excluded from the gross income of the employee. In addition, amounts received by an employee under such a plan generally are excluded from gross income to the extent that the amounts received are paid, directly or indirectly, to reimburse the employee for expenses incurred by the employer for the medical care of the employee, the employee's spouse, or a dependent of the employee. For this purpose, expenses incurred for medical care are defined in the same manner as under the rules regarding the deduction for medical expenses.

A cafeteria plan is an employer-sponsored arrangement under which employees can elect among cash and certain employer-provided qualified benefits. No amount is included in the gross income of a participant in a cafeteria plan merely because the participant has the opportunity to make such an election. Employer-provided accident or health coverage is one of the benefits that may be offered under a cafeteria plan.

A flexible spending arrangement (FSA) is an arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. An FSA may be part of a cafeteria plan or provided by an employer outside a cafeteria plan. FSAs are commonly used to reimburse employees for medical expenses not covered by insurance. If certain requirements are satisfied, amounts reimbursed for nontaxable benefits from an FSA are excludable from income.

### **Health care continuation rules**

The health care continuation rules require that an employer must provide qualified beneficiaries the opportunity to continue to participate for a specified period in the employer's health plan after the occurrence of certain events (such as termination of employment) that would have terminated such participation. Individuals electing continuation coverage can be required to pay for such coverage.

### **Life insurance company reserve rules**

In general, life insurance companies are allowed a deduction for a net increase in reserves and must take into income any net decreases in reserves. Present law prescribes a tax reserve method based on the nature of the contract. For noncancellable accident and health insurance contracts, the prescribed method is a two-year full preliminary term method. Long-term care insurance reserves are treated like noncancellable accident and health insurance for this purpose and, therefore, are subject to the two-year full preliminary term method of reserves. In no event is the tax reserve for any contract as of any time permitted to exceed the amount which would be taken into account in determining statutory reserves (i.e., set forth on the annual statement for State law reporting purposes). Under the National Association of Insurance Commissioners (NAIC) Long-Term Care Insurance Model Act and Regulations, which have been adopted by some States, by contrast, long-term care insurance reserves are calculated under a one-year full preliminary term method. Thus, because of this inconsistency, in some cases life insurance companies establish reserves for long-term care insurance contracts earlier for State regulatory purposes than they do for Federal tax purposes. In addition, some life insurance companies have voluntarily complied with the NAIC model act and regulations, even though not required to do so in all cases.

Changes in reserve amounts due to changes in the basis on which reserves are calculated are generally spread over a 10-year period.

## **Description of Proposal**

### **Tax treatment and definition of long-term care insurance contracts and qualified long-term care services**

#### **In general**

A long-term care insurance contract would be treated as an accident and health insurance contract. A plan of an employer providing coverage under a long-term care insurance contract generally would be treated as an accident and health plan; however, coverage under a long-term care insurance contract would not be excludable by an employee if provided through a cafeteria plan, and expenses for long-term care services could not be reimbursed under an FSA. Amounts (other than policyholder dividends or premium refunds) received under a long-term care insurance contract would be excludable as amounts received for personal injuries or sickness. A contract would not fail to be treated as a long-term care insurance contract solely because it provides for payments on a per diem or other periodic basis without regard to expenses during the period. If the aggregate payments under all per diem contracts issued by the same insurer with respect to any one insured exceed \$150 per day, then the excess would not be excludable. A payor of long-term care benefits in excess of \$150 per day would be required to report the amount of such benefits. The \$150 limit would be indexed.

Premiums for long-term care insurance would be treated as medical expenses for purposes of the itemized deduction for medical expenses. Similarly, expenses for qualified long-term care services would be treated as medical expenses for purposes of the itemized deduction. The \$150 limitation would not apply with respect to the deduction of long-term care premiums or expenses as medical expenses.

#### Definition of long-term care insurance contract

A long-term care insurance contract would be defined as any insurance contract that provides only coverage of qualified long-term care services and that meets other requirements. The other requirements would be that (1) premiums are level annual payments over the life of the contract (or 20 years, if shorter), (2) refunds (other than refunds on death of the insured or complete surrender or cancellation of the contract) and dividends under the contract may be used only to reduce future premiums or increase future benefits, (3) the contract prohibits borrowing, assignment, or pledging, (4) the contract generally does not pay or reimburse expenses reimbursable under Medicare (except where Medicare is a secondary payor).

The proposal would provide that a long-term care insurance contract that coordinates its benefits with those provided under Medicare, and health insurance policies (other than Medigap policies) that pay in addition to other coverage, may be sold without violating other laws.

#### Definition of qualified long-term care services

Qualified long-term care services would mean necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative and maintenance (including personal care) services, that are required by a functionally impaired individual. Such services would be provided pursuant to a plan of care prescribed by a licensed health care practitioner, and would have as their primary purpose the provision of needed assistance with one or more activities of daily living, or substantial supervision to protect from threats to health and safety due to substantial cognitive impairment.

A functionally impaired individual would be one who has been certified within the previous 12 months by a licensed health care practitioner as (1) being unable to perform (without substantial assistance) at least 2 activities of daily living, or (2) requiring substantial supervision to protect such individual from threats to health and safety due to substantial cognitive impairment. Activities of daily living would be eating, toileting, transferring, bathing, dressing and continence.

A licensed health care practitioner would be defined as a physician, registered professional nurse, qualified community care case manager, or other qualified individual who meets such requirements as may be prescribed by the Secretary of the Treasury, provided such person is not a relative of the individual receiving care. A qualified community care case manager would mean an individual or entity with experience in assessing individuals to determine functional and cognitive impairment, and with experience in providing case management services and preparing individual care plans, and that meets requirements prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

#### Itemized deduction for medical expenses

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent would be treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the present-law floor of 7.5 percent of adjusted gross income). Amounts received under a long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other basis) would be treated as reimbursement for expenses for this purpose. For purposes of this deduction, qualified long-term care services would not include services provided to an individual by a relative or a related corporation. A deduction would also be provided for premiums for insurance covering otherwise deductible expenses for medical care that is provided under a long-term care insurance contract.

#### Long-term care riders on life insurance contracts

In the case of long-term care insurance coverage provided by a rider on a life insurance contract, the requirements applicable to long-term care insurance contracts would apply as if the portion of the contract providing such coverage were a separate contract. The term "portion" would mean only the terms and benefits that are in addition to the terms and benefits under the life insurance contract without regard to long-term care coverage. The guideline premium limitation and adjustment rules applicable under present law to the life insurance contract would be modified appropriately to take account of charges with respect to the long-term care rider.

#### Life insurance company reserves

In determining reserves for insurance company tax purposes, the Federal income tax reserve method would be the method prescribed by the National Association of Insurance Commissioners, but no earlier and not in excess of the reserve under the method actually used by the company with respect to the long-term care insurance contract for determining statutory reserves.

### Health care continuation rules

The health care continuation rules would not apply to coverage under a long-term care insurance contract.

### Consumer protection provisions

Under the proposal, long-term care insurance contracts, and issuers of contracts, would be required to satisfy certain provisions of the long-term care insurance model Act and model regulations promulgated by the National Association of Insurance Commissioners (as adopted as of January 1993). The policy requirements relate to disclosure, nonforfeitability, guaranteed renewal or noncancellability, prohibitions on limitations and exclusions, extension of benefits, continuation or conversion of coverage, discontinuance and replacement of policies, unintentional lapse, post-claims underwriting, minimum standards, inflation protection, preexisting conditions, and prior hospitalization. The proposal also would provide disclosure and nonforfeiture requirements. The nonforfeiture provision would give consumers the option of selecting reduced paid-up insurance, extended term insurance, or a shortened benefit period in the event the policyholder is unable to continue to pay premiums. The requirements for issuers of long-term care insurance contracts relate to application forms, reporting requirements, marketing, appropriateness of purchase, format, delivering a shopper's guide, right to return, outline of coverage, group plans, policy summary, monthly reports on accelerated death benefits, and incontestability period. A tax would be imposed equal to \$100 per policy per day for failure to satisfy these requirements.

Nothing in the proposal would prevent a State from establishing, implementing or continuing standards related to the protection of policyholders of long-term care insurance policies, if such standards are not inconsistent with standards established under the proposal.

### Effective Date

The proposals relating to treatment of long-term care insurance or plans would apply to contracts issued after December 31, 1995. The proposals relating to treatment of qualified long-term care services as medical care would apply to taxable years beginning after December 31, 1995. The proposal would provide that no inference is intended as to the tax treatment of long-term care insurance and services prior to the effective date.

A contract providing for payment or reimbursement of services similar to qualified long-term care services, that is issued on or before December 31, 1995, could be exchanged for a long-term care insurance contract tax-free until June 30, 1997. Taxable gain would be recognized to the extent money or other property is received in the exchange.

The issuance or conformance of a rider to a life insurance contract providing long-term care insurance coverage would not be treated as a modification or a material change for purposes of

applying present-law rules relating to flexible premium contracts and the definition of life insurance contracts and modified endowment contracts.

The change in treatment of reserves for long-term care insurance contracts would be effective for contracts issued after December 31, 1995.

The provision relating to treatment of contracts that coordinate benefits with those provided under Medicare is effective November 5, 1990.

The proposal relating to consumer protections would be apply to contracts issued after December 31, 1995 with respect to policy requirements, and to actions taken after December 31, 1995 with respect to actions by insurers.



## **B. Treatment of Accelerated Death Benefits Under Life Insurance Contracts**

### **Present Law**

#### **Treatment of amounts received under a life insurance contract**

If a contract meets the definition of a life insurance contract, gross income does not include insurance proceeds that are paid pursuant to the contract by reason of the death of the insured (sec. 101(a)). In addition, the undistributed investment income ("inside buildup") earned on premiums credited under the contract is not subject to current taxation to the owner of the contract. The exclusion of death benefits from taxation applies regardless of whether the death benefits are paid as a lump sum or otherwise.

Amounts received under a life insurance contract (other than a modified endowment contract) prior to the death of the insured are includible in the gross income of the recipient to the extent that the amount received constitutes cash value in excess of the taxpayer's investment in the contract (generally, the investment in the contract is the aggregate amount of premiums paid less amounts previously received that were excluded from gross income).

If a contract fails to be treated as a life insurance contract under a statutory definition, inside buildup on the contract is generally subject to tax.

#### **Proposed regulations on accelerated death benefits**

The Treasury Department has issued proposed regulations<sup>1</sup> under which certain "qualified accelerated death benefits" paid by reason of the terminal illness of an insured would be treated as paid by reason of the death of the insured and therefore qualify for exclusion under section 101. In addition, the proposed regulations would permit an insurance contract that includes a qualified accelerated death benefit rider to qualify as a life insurance contract under section 7702. Thus, the proposed regulations provide that including this benefit would not cause an insurance contract to fail to meet the definition of a life insurance contract.

Under the proposed regulations, a benefit would qualify as a qualified accelerated death benefit only if it meets three requirements. First, the accelerated death benefit can be payable only if the insured becomes terminally ill. Second, the amount of the benefit must equal or exceed the present value of the reduction in the death benefit otherwise payable.<sup>2</sup> Third, the cash surrender value

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<sup>1</sup> Prop. Treas. Reg. Secs. 1.101-8, 1.7702-0, 1.7702-2, and 1.7702A-1 (December 15, 1992).

<sup>2</sup> For purposes of determining the present value under the proposed regulations, the maximum permissible discount rate would be the greater of (1) the applicable Federal rate that applies under the discounting rules for property and casualty insurance loss reserves, and (2) the interest rate applicable to policy loans under the contract. Also, the present value would be determined

and the death benefit payable under the policy must be reduced proportionately as a result of the accelerated death benefit.

For purposes of the proposed regulations, an insured would be treated as terminally ill if he or she has an illness that, despite appropriate medical care, the insurer reasonably expects to result in death within 12 months from the payment of the accelerated death benefit. The proposed regulations do not apply to viatical settlements.

### **Description of Proposal**

#### **In general**

The proposal would provide an exclusion from gross income as an amount paid by reason of the death of an insured for (1) amounts received under a life insurance contract and (2) amounts received for the sale or assignment of a life insurance contract to a viatical settlement provider, provided the insured under the life insurance contract is terminally ill. For this purpose, an individual would be considered terminally ill if the insurer determines, after receipt of an acceptable certification by a licensed physician, that the individual has an illness or physical condition that is reasonably expected to result in death within 12 months of the certification.

The proposal would not apply in the case of an amount paid to any taxpayer other than the insured, if such taxpayer has an insurable interest by reason of the insured being a director, officer or employee of the taxpayer, or by reason of the insured being financially interested in any trade or business carried on by the taxpayer.

#### **Amounts received under a life insurance contract**

The exclusion for amounts received under a life insurance contract would be applicable only if two requirements are met. First, under a present value test, the amount received must equal or exceed the present value of the reduction in the death benefit otherwise payable under the life insurance contract. Second, under a ratio test, the payment of the amount must not reduce the cash surrender value of the contract proportionately more than the death benefit payable under the contract. In other words, the percentage derived by dividing the cash surrender value of the contract immediately after the distribution by the cash surrender value of the contract immediately before the distribution must equal or exceed the percentage derived by dividing the death benefit payable immediately after the distribution by the death benefit payable immediately before the distribution. The amount received would include a series of payments.

For purposes of the present value test, the present value of the reduction in the death benefit would be determined by reference to a maximum permissible discount rate, and by assuming that the

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assuming that the death benefit would have been paid twelve months after payment of the accelerated death benefit.

death benefit would have been paid on the date that is 12 months from the date of the physician's certification. The maximum permissible discount rate would be the highest of the following three interest rates: (1) the 90-day Treasury bill yield (as most recently published); (2) Moody's Corporate Bond Yield Average-Monthly Average Corporates (or any successor rate) for the month ending two months before the date the rate is determined; or (3) the rate used to determine cash surrender values under the contract during the applicable period plus 1 percent per annum. The rate would be determined as of the date (or dates) that the payment is made.

If the accelerated death benefit under the contract is paid in connection with a lien against the death benefit rather than an actual reduction in the death benefit on a discounted basis, then the amount of the lien, and interest charges with respect to any amount in connection with the lien, would be taken into account so as to achieve parity between use of the lien method and use of a discounted payment.

For life insurance company tax purposes, the proposal would treat a qualified accelerated death benefit rider to a life insurance contract as life insurance. A qualified accelerated death benefit rider would be any rider on a life insurance contract that provides for a distribution to an individual upon the insured becoming a terminally ill individual (as defined above), but only if such payments under the rider are payments that are excludible under this proposal.

### **Viatical settlements**

The proposal would provide an exclusion for the amount paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of an insured individual who is terminally ill. A viatical settlement provider would be any person that regularly engaged on the trade or business of purchasing or taking assignments of life insurance contracts on the lives of terminally ill individuals and either (1) is licensed for such purposes in the State in which the insured resides, or (2) if the person is not required to be licensed by that State, meets the requirements of sections 8 and 9 of the Viatical Settlements Model Act issued by the National Association of Insurance Commissioners (NAIC) (relating to disclosure requirements and general rules for a viatical settlement contract). In addition, any such sale or assignment of a life insurance contract would have to satisfy the requirements of the section of the Viatical Settlements Model Regulation issued by the NAIC relating to standards for evaluation of reasonable payments, including discount rates.

### **Effective Date**

The proposal would apply to amounts received after December 31, 1995. The discount rules applicable to payments under life insurance contracts would not apply to any amount received before July 1, 1996. The proposal treating a qualified accelerated death benefit rider as life insurance for life insurance company tax purposes would take effect on January 1, 1996. The issuance of a qualified accelerated death benefit rider to a life insurance contract, or the addition of any provision required to conform an accelerated death benefit rider to these proposals, would not be treated as a modification or material change of the contract for purposes of the definition of a life insurance

contract and a modified endowment contract (and would not affect the issue date of any contract under present-law rules relating to flexible premium contracts).

## **C. Medical Savings Accounts**

### **Present Law**

Under present law, the tax treatment of health insurance expenses depends on whether the individual is an employee or self employed, and whether the individual is covered under an employer-sponsored health plan. Employer contributions to a health plan for coverage for the employee and the employee's spouse and dependents is excludable from the employee's income. In addition, employers generally can deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for their employees. The exclusion and deduction are generally also available in the case of owners of subchapter C corporations who are also employees.

Self-employed individuals are entitled to a deduction for 30 percent of the amount paid for health insurance for a self-employed individual and the individual's spouse and dependents. The 30-percent deduction is also available to more than 2-percent shareholders of subchapter S corporations.

Individuals who itemize their tax deductions may deduct unreimbursed medical expenses (including expenses for medical insurance) paid during the year to the extent that the total of such expenses exceeds 7.5 percent of the individual's adjusted gross income ("AGI"). Medical expenses include the expenses of the individual and his or her spouse or dependents.

### **Description of Proposal**

#### **In general**

In general, the proposal would permit individuals who are covered by a high-deductible health plan to maintain a medical savings account ("MSA"). Only one MSA could be maintained per family. Within limits, contributions to an MSA would be deductible if made by the individual, or alternatively, would be excludable from an employee's income if made by the employer. An individual could not make contributions if the individual is eligible for employer-subsidized health care (or to receive employer contributions to an MSA). Income earned on amounts held in an MSA would not be currently includible in income. Withdrawals from an MSA would be excludable from income if used for medical expenses for the individual and his or her spouse or dependents.

#### **Contributions to MSAs**

The proposal would extend the present-law tax treatment for medical expenses to MSA contributions (within certain limits). Thus, an individual could deduct MSA contributions to the extent the contributions, together with other medical expenses for the year exceed 7-1/2 percent of AGI. Self-employed individuals would be able to deduct 30 percent of MSA contributions.

Employer contributions to an MSA would be excludable from income for income and employment tax purposes. An individual would not be eligible to make contributions to an MSA if the individual is eligible to receive employer-subsidized health care (or to receive employer contributions to an MSA).

The maximum annual amount of contributions that could be taken into account for purposes of the deductions for individual contributions or the exclusion for employer contributions would be limited to the lesser of (1) the deductible under the high deductible health plan, and (2) \$2,000 (\$4,000 in the case of family coverage). The dollar limits would be indexed for medical inflation after 1996.

This maximum contribution limit would be determined separately for each month based on the individual's status in that month, including: (1) whether the individual is covered under a high deductible plan, (2) whether the high-deductible health plan covers only the individual or also a spouse and dependents, and (3) the amount of the deductible under the plan. The maximum annual contribution would be the sum of the monthly contribution limits.

A high deductible plan would be a plan with an annual deductible of at least \$1,500 in the case of individual coverage and \$3,000 in the case of coverage of more than one person. These dollar amounts would be indexed for medical inflation after 1996.

Contributions to an MSA for a taxable year could be made until the due date for filing the individual's tax return for the year (determined without regard to extensions).

The proposal would not expressly limit the timing of employer contributions. Thus, for example, an employer could make monthly contributions or a single annual contribution to an MSA. Employer contributions made through a cafeteria plan would not be excludable from income.

### **Definition and tax treatment of MSAs**

In general, an MSA would be a trust (or a custodial account) created exclusively for the benefit of the beneficiaries of the trust that meets requirements similar to those applicable to individual retirement arrangements ("IRAs").<sup>3</sup> The trustee of an MSA could be a bank, insurance

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<sup>3</sup> For example, MSA contributions (other than amounts rolled over from another MSA) would have to be in cash, no MSA assets could be invested in life insurance contracts, MSA assets could not be commingled with other property except in a common trust fund or common investment fund, and an account holder's interest in an MSA would be required to be nonforfeitable. In addition, if an account holder engages in a prohibited transaction with respect to an MSA or pledges assets in an MSA, rules similar to those for IRAs would apply, and any amounts treated as distributed to the account holder under these rules would be treated as not used for qualified medical expenses.

company,<sup>4</sup> or other person that demonstrates to the satisfaction of the Secretary that the manner in which such person will administer the trust will be consistent with applicable requirements.

Earnings in amounts in an MSA would not be currently taxed.

### **Distributions from an MSA**

Distributions from an MSA that are used to pay the unreimbursed qualified medical expenses of the individual or the individual's spouse or dependents would not be taxable. Qualified medical expenses would generally be defined as under the rules relating to the itemized deduction for medical expenses (as modified by the proposal), and thus would include amounts expended for qualified long-term care services. Qualified medical expenses would not include any insurance premiums (including premiums for the high-deductible health plan), except for premiums for long-term care insurance, health care continuation coverage for certain individuals who have lost employer-provided health coverage, and coverage while the individual is receiving unemployment compensation. Qualified medical expenses paid with distributions from an MSA that are excludable from gross income could not be taken into account for purposes of the itemized deduction for medical expenses.

Distributions for purposes other than qualified medical expenses would be taxable. An additional tax of 10 percent of the taxable amount also would apply unless the distribution is made after the individual attains the age of 59-1/2, dies, or becomes disabled.

If certain events occur, an MSA would cease to be an MSA. This could happen if an individual engages in a prohibited transaction during a taxable year. In addition, an MSA would cease to be treated as an MSA unless the individual remains in a high-deductible health plan for at least two years after the MSA is established. This two-year rule would not apply to individual who does not remain in a high-deductible health plan because of the termination of employment. If an MSA ceases to be treated as an MSA, the individual would be treated as taking the account balance as a distribution for purposes other than qualified medical expenses.

Rollovers from one MSA to another MSA would be permitted without income inclusion if made within 60 days of distribution.

The proposal would include a correction mechanism so that if contributions for a year (whether made by the individual or the employer) exceed the deduction limit for the year, the excess contribution can be withdrawn tax free. In order for tax-free treatment to apply, the excess contributions would have to be withdrawn before the due date (including extensions) for

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<sup>4</sup> The acquisition expenses of an insurance company relating to the establishment of an MSA would not be subject to the rules relating to the capitalization of policy acquisition expenses.

filing the individual's tax return for the year and be accompanied by the amount of income attributable to such contribution.

Upon the death of the individual, an MSA would not be subject to estate tax, and income tax treatment of an MSA would depend on who is the individual's beneficiary. If the beneficiary is the surviving spouse, then the spouse may continue the MSA as his or her own. Thus, new contributions could be made by the spouse (or the spouse's employer) if the spouse is in a high deductible plan. Tax-free distributions could be made from the account for the benefit of the spouse and his or her dependents (and any subsequent spouse).

If the beneficiary is not the surviving spouse, then the MSA balance would be included in the income of the beneficiary in the year of death. If the individual does not designate a beneficiary, then the MSA account balance would be includible in the individual's income for the year of death.

#### **Effective Date**

The proposal would be effective with respect to taxable years beginning after December 31, 1995.



## **D. Increase Dollar Limits for Burial Insurance**

### **Present Law**

To qualify as a life insurance contract for Federal income tax purposes, a contract must be a life insurance contract under the applicable State or foreign law and must satisfy either of two alternative tests: (1) a cash value accumulation test or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement.<sup>5</sup> Under these rules, the death benefit is generally deemed not to increase.

Special rules apply with respect to a contract that is purchased to cover payment of burial expenses or in connection with prearranged funeral expenses. For such a contract, death benefit increases may be taken into account in applying the cash value accumulation test if the contract (1) has an initial death benefit of \$5,000 or less and a maximum death benefit of \$25,000 or less, and (2) provides for a fixed predetermined annual increase not to exceed 10 percent of the initial death benefit or 8 percent of the death benefit at the end of the preceding year.

### **Description of Proposal**

The proposal would increase the dollar limits applicable in the case of an insurance contract to cover payment of burial expenses or in connection with prearranged funeral expenses. For such a contract, death benefit increases could be taken into account in applying the cash value accumulation test if the contract has an initial death benefit of \$7,000 or less and a maximum death benefit of \$30,000 or less (and other requirements of present law are met). In addition, these dollar limits would be adjusted annually, after the first year, for inflation in accordance with the consumer price index.

### **Effective Date**

The proposal would be effective for contracts entered into after December 31, 1995.

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<sup>5</sup> A contract satisfies the cash value accumulation test if the cash surrender value of the contract may not at any time exceed the net single premium that would have to be paid at such time to fund future benefits under the contract. A contract satisfies the guideline premium and cash value corridor tests if the premiums paid under the contract do not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums, and if the death benefit under the contract is not less than a varying statutory percentage of the cash surrender value of the contract.

## **E. Health Insurance Organizations Eligible for Benefits of Section 833**

### **Present Law**

An organization described in section 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. Special rules apply to certain eligible health insurance organizations. Eligible health insurance organizations are (1) Blue Cross or Blue Shield organizations existing on August 16, 1986, which have not experienced a material change in structure or operations since that date, and (2) other organizations that meet certain community-service-related requirements and substantially all of whose activities involve the providing of health insurance. Section 833 provides that eligible organizations are generally treated as stock property and casualty insurance companies.

Section 833 provides a special deduction for eligible organizations, equal to 25 percent of the claims and expenses incurred during the year, less the adjusted surplus at the beginning of the year. This deduction is calculated by computing surplus, taxable income, claims incurred, expenses incurred, tax-exempt income, net operating loss carryovers, and other items attributable to health business. The deduction may not exceed taxable income attributable to health business for the year (calculated without regard to this deduction).

In addition, section 833 eliminates, for eligible organizations, the 20-percent reduction in unearned premium reserves that applies generally to all property and casualty insurance companies.

### **Description of Proposal**

The proposal would apply the special rules under section 833 to the same extent they are provided to certain existing Blue Cross or Blue Shield organizations, in the case of any organization that (1) is not a Blue Cross or Blue Shield organization existing on August 16, 1986, and (2) otherwise meets the requirements of section 833 (including the requirement of no material change in operations or structure since August 16, 1986). Under the proposal, an organization qualifies for this treatment only if (1) it is not a health maintenance organization and (2) it is organized under and governed by State laws which are specifically and exclusively applicable to not-for-profit health insurance or health service type organizations.

### **Effective Date**

The proposal would be effective for taxable years ending after October 13, 1995.

## IV. ESTATE AND GIFT TAX REFORM

### A. Reduction in Estate Tax for Qualified Family-Owned Businesses

#### Present Law

##### Application of the estate and gift tax

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.<sup>1</sup> Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over \$3 million (Code sec. 2001(c)).

The amount of gift tax payable for any calendar year generally is determined by applying the tax rates (from the unified rate schedule) to the cumulative lifetime taxable transfers made by the taxpayer, and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer during his lifetime or at death and then subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

A taxpayer may exclude \$10,000 of gifts made to any one donee during a calendar year (sec. 2503).

##### Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. Since 1987, the unified credit amount has been fixed at \$192,800 (sec. 2010), which effectively exempts a total of \$600,000 in cumulative taxable transfers from the estate and gift tax. The benefits of the unified credit (and the graduated estate and gift tax rates) are phased-out by a 5-percent surtax imposed upon cumulative taxable transfers over \$10 million and not exceeding \$21,040,000 (sec. 2001(c)(2)).<sup>2</sup>

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<sup>1</sup> Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

<sup>2</sup> Thus, if a taxpayer has made cumulative taxable transfers exceeding \$21,040,000, his or her average transfer tax rate will be 55 percent under present law.

The unified credit originally was enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level that effectively exempted \$175,625 of taxable transfers from the estate and gift tax in 1981 (i.e., a unified credit of \$47,000). The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an effective exemption of \$225,000 in 1982 to an effective exemption of \$600,000 in 1987. The unified credit has not been increased since 1987.

### **Special use valuation of farms and other closely-held businesses**

Generally, for Federal transfer tax purposes, the value of property is its fair market value. Under section 2032A, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value. The maximum reduction in the value of such real property resulting from an election under section 2032A is \$750,000.

If, after the special use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death (15 years for decedents dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special use valuation.

### **Installment payment of estate tax attributable to closely-held businesses**

Under section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely-held business in installments over, at most, a 14-year period. To qualify for the election, the business must be an active trade or business and the value of the decedent's interest in the closely-held business must exceed 35 percent of the decedent's adjusted gross estate.

If an election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short-term rate plus 3 percentage points). Under section 6601(j), however, a special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1,000,000 in value of the closely-held business. The maximum amount that may be subject to the four-percent rate is the lower of (1) \$345,800 (i.e., the amount of estate tax on the first \$1,000,000), less the amount of allowable unified credit, or (2) the amount of estate tax attributable to the closely-held business that is being paid in installments pursuant to section 6166.

## **Description of Proposal**

### **Overview**

The proposal would provide special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate. Subject

to the requirements set forth below, the proposal would exclude the first \$1.5 million of value in qualified family-owned business interests from the decedent's estate, and also would exclude from the estate 50 percent of the value of qualified family-owned business interests between \$1.5 million and \$5 million. Thus, the total amount of exclusion available per decedent for qualified family-owned business interests would be equal to \$3.25 million (i.e., \$1.5 million plus 50 percent of \$3.5 million).

This new exclusion for qualified family-owned business interests would be provided in addition to the present-law unified credit (which effectively exempts \$600,000 of taxable transfers from the estate and gift tax) and the special-use provisions of section 2032A (which permit the exclusion of up to \$750,000 in value of a qualifying farm or other closely-held business from a decedent's estate).

### **Qualified family-owned business interests**

For purposes of the proposal, a qualified family-owned business interest would be defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. Under the proposal, members of an individual's family would be defined using the same definition as is used for the special-use valuation rules of section 2032A, and thus would include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants. In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special rules would apply.

An interest in a trade or business would not qualify if the business's (or a related entity's) stock or securities were publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also would not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income (as defined in section 543). The value of qualified family-owned business interests would not include any cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business. The value of the qualified family-owned business interests also would not include certain other passive assets.

### **Qualifying estates**

A decedent's estate would qualify for the special treatment only if the decedent was a U.S. citizen or resident at the time of death, and the aggregate value of the decedent's qualified family-owned business interests that are passed to qualified heirs exceeds 50 percent of the decedent's adjusted gross estate (the "50-percent liquidity test"). For this purpose, qualified heirs include any individual who has been actively employed by the trade or business for at least 10 years prior to

the date of the decedent's death, and members of the decedent's family. If a qualified heir is not a citizen of the United States, any qualified family-owned business interest acquired by that heir must be held in a trust meeting requirements similar to those imposed on qualified domestic trusts (under present-law section 2056A(a)), or through any other security arrangement that meets the satisfaction of the Secretary. The 50-percent liquidity test generally would be applied by adding all transfers of qualified family-owned business interests made by the decedent to qualified heirs at the time of the decedent's death, plus certain lifetime gifts of qualified family-owned business interests made to members of the decedent's family, and comparing this total to the decedent's adjusted gross estate. To the extent that a decedent held qualified family-owned business interests in more than one trade or business, all such interests would be aggregated for purposes of applying the 50-percent liquidity test.

The 50-percent liquidity test would be calculated using a ratio, the numerator and denominator of which are described below.

The numerator would be equal to the aggregate qualified family-owned business interests that are includible in the decedent's gross estate and are passed from the decedent to a qualified heir, plus any lifetime transfers of qualified business interests that were made by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests have been continuously held by members of the decedent's family and were not otherwise includible in the decedent's gross estate, and reduced by certain indebtedness of the estate.

The denominator would be equal to the decedent's gross estate, reduced by any indebtedness of the estate, and increased by the amount of the following transfers, to the extent not already included in the decedent's gross estate: (a) any lifetime transfers of qualified business interests that were made by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests have been continuously held by members of the decedent's family, plus (b) any other transfers from the decedent to the decedent's spouse that were made within 10 years of the date of the decedent's death, plus (c) any other transfers made by the decedent within three years of the decedent's death, except non-taxable transfers made to members of the decedent's family. The Secretary of Treasury would be granted authority to disregard de minimis gifts. In determining the amount of gifts made by the decedent, any gift that the donor and the donor's spouse elected to have treated as a split gift (pursuant to sec. 2513) would be treated as made one-half by each spouse for purposes of this proposal.

### **Participation requirements**

To qualify for the beneficial treatment provided under the proposal, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, each qualified heir (or a member of the qualified heir's family) would be required to materially participate in the trade or business for at least five years of any 8-year period within ten years following the decedent's death. For this purpose, "material participation" would be defined as

under present-law section 2032A (special use valuation) and the regulations promulgated thereunder. Under such regulations, no one factor is determinative of the presence of material participation and the uniqueness of the particular industry (e.g., timber, farming, manufacturing, etc.) must be considered. Physical work and participation in management decisions are the principal factors to be considered. For example, an individual who personally manages the business fully generally would be considered to be materially participating in the business regardless of the number of hours worked, as long as any necessary functions are performed.

If a qualified heir rents qualifying property to a member of the qualified heir's family on a net cash basis, and that family member materially participates in the business, the material participation requirement would be considered to have been met with respect to the qualified heir for purposes of this proposal.

### **Recapture provisions**

The benefit of the exclusions for qualified family-owned business interests would be subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs: (1) the qualified heir ceases to meet the material participation requirements (i.e., if neither the qualified heir nor any member of his or her family has materially participated in the trade or business for at least five years of any 8-year period); (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a conservation contribution under section 170(h); (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship. A qualified heir who loses U.S. citizenship may avoid such recapture by placing the qualified family-owned business assets into a trust meeting requirements similar to a qualified domestic trust (as described in present law section 2056A(a)), or through any other security arrangement that meets the satisfaction of the Secretary of Treasury.

If one of the above recapture events occurs, an additional tax would be imposed on the date of such event. The portion of the reduction in estate taxes that would be recaptured would be dependent upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business after the decedent's death. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest would be recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes would be recaptured; if the participation was for at least seven years but less than eight years, 60 percent would be recaptured; if the participation was for at least eight years but less than nine years, 40 percent would be recaptured; and if the participation was for at least nine years but less than ten years, 20 percent of the reduction in estates taxes would be recaptured. In general, there would be no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under present-law section 2032A,

however, the 10-year recapture period could be extended for a period of up to two years if the qualified heir did not begin to use the property for a period of up to two years after the decedent's death.

If a recapture event occurs with respect to any qualified family-owned business interest (or portion thereof), the amount of reduction in estate taxes attributable to that interest would be determined on a proportionate basis. For example, if the decedent's estate included \$15 million in qualified family-owned business interests and \$5 million of such interests received beneficial treatment under this proposal, one-third of the value of the interest disposed of would be deemed to have received the benefits provided under this proposal.

#### **Effective Date**

The proposal would be effective with respect to the estates of decedents dying after December 31, 1995.



## **B. Increase Estate and Gift Tax Unified Credit**

### **Present Law**

#### **Application of the estate and gift tax**

A gift tax is imposed on lifetime transfers by gift and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.<sup>3</sup> Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over \$3 million.

The amount of gift tax payable for any calendar year generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable lifetime and deathtime transfers made by the taxpayer and then subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

#### **Unified credit**

A unified credit is available with respect to taxable transfers by gift and at death. Since 1987, the unified credit amount has been fixed at \$192,800, which effectively exempts a total of \$600,000 in cumulative taxable transfers from the estate and gift tax. The benefits of the unified credit (and the graduated estate and gift tax rates) are phased out by a five-percent surtax imposed upon cumulative taxable transfers over \$10 million and not exceeding \$21,040,000.<sup>4</sup>

The unified credit was originally enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level that effectively exempted \$175,625 of taxable transfers from the estate and gift tax in 1981 (i.e., a unified credit of \$47,000). The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an

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<sup>3</sup> Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

<sup>4</sup> Thus, if a taxpayer has made cumulative taxable transfers exceeding \$21,040,000, his or her effective transfer tax rate will be 55 percent under present law.

effective exemption of \$225,000 in 1982 to an effective exemption of \$600,000 in 1987. The unified credit has not been increased since 1987.

### **Description of Proposal**

The proposal would increase the present-law unified credit over a six-year period beginning in 1996, from an effective exemption of \$600,000 to an effective exemption of \$750,000. The increase would be phased in as follows:

<b><u>Decedents dying and gifts made in</u></b>	<b><u>Effective exemption</u></b>
1996 .....	\$625,000
1997 .....	\$650,000
1998 .....	\$675,000
1999 .....	\$700,000
2000 .....	\$725,000
2001 and thereafter .....	\$750,000

Conforming amendments to reflect the increased unified credit would be made (1) to the 5-percent surtax in order to permit the proper phase out of the increased unified credit, (2) to the general filing requirements for an estate tax return under section 6018(a), and (3) to the amount of the unified credit allowed under section 2102(c)(3) with respect to nonresident aliens with U.S. situs property who are residents of certain treaty countries.

### **Effective Date**

The proposal would apply to the estates of decedents dying, and gifts made, after December 31, 1995.

## **C. Reduction in Estate Tax for Certain Land Subject to Permanent Conservation Easement**

### **Present Law**

#### **Application of the estate and gift tax**

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.<sup>5</sup> Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over \$3 million (Code sec. 2001(c)).

The amount of gift tax payable for any calendar year generally is determined by applying the tax rates (from the unified rate schedule) to the cumulative lifetime taxable transfers made by the taxpayer, and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer during his lifetime or at death and then subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

A taxpayer may exclude \$10,000 of gifts made to any one donee during a calendar year (sec. 2503).

#### **Unified credit**

A unified credit is available with respect to taxable transfers by gift and at death. Since 1987, the unified credit amount has been fixed at \$192,800 (sec. 2010), which effectively exempts a total of \$600,000 in cumulative taxable transfers from the estate and gift tax. The benefits of the unified credit (and the graduated estate and gift tax rates) are phased-out by a 5-percent surtax imposed upon cumulative taxable transfers over \$10 million and not exceeding \$21,040,000 (sec. 2001(c)(2)).<sup>6</sup>

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<sup>5</sup> Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

<sup>6</sup> Thus, if a taxpayer has made cumulative taxable transfers exceeding \$21,040,000, his or her average transfer tax rate will be 55 percent under present law.

The unified credit originally was enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level that effectively exempted \$175,625 of taxable transfers from the estate and gift tax in 1981 (i.e., a unified credit of \$47,000). The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an effective exemption of \$225,000 in 1982 to an effective exemption of \$600,000 in 1987. The unified credit has not been increased since 1987.

### **Special use valuation of farms and other closely-held businesses**

Generally, for Federal transfer tax purposes, the value of property is its fair market value. Under section 2032A, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value. The maximum reduction in the value of such real property resulting from an election under section 2032A is \$750,000.

If, after the special use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special use valuation.

### **Conservation easements**

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). A "conservation purpose" is (1) preservation of land for outdoor recreation by, or the education of, the general public, (2) preservation of natural habitat, (3) preservation of open space for scenic enjoyment of the general public or pursuant to a governmental conservation policy, and (4) preservation of historically important land or certified historic structures. Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.<sup>7</sup>

### **Description of Proposal**

#### **Reduction in estate taxes for certain land subject to permanent conservation easement**

The proposal would provide that an executor may elect to exclude from the estate tax 50 percent of the value of any land subject to a qualified conservation easement that meets the following

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<sup>7</sup> A member of the transferor's family would include: (1) his or her ancestors; (2) his or her spouse; (3) a lineal descendant of the decedent, the decedent's spouse or the decedent's parents; and (4) the spouse of any of the foregoing lineal descendants.

requirements: (1) the land must be located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area; (2) the land must have been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of section 170(h)) of a qualified real property interest (as generally defined in section 170(h)(2)(C)) had been granted by the transferor or a member of his or her family. The basis of such land acquired at death would be a carryover basis (i.e., the basis would not be stepped-up to its fair market value at death). For purposes of the proposal, preservation of a historically important land area or a certified historic structure would not qualify as a conservation purpose. Debt-financed property would not be eligible for the exclusion.

The exclusion from estate taxes would not extend to the value of any development rights retained by the decedent or donor, although payment for estate taxes on retained development rights may be deferred for up to two years. For this purpose, retained development rights would be any rights retained to establish or use any structure (and the land immediately surrounding it) for sale, rent or any other commercial purpose, which is not subordinate to and directly supportive of (1) the conservation purpose identified in the easement, or (2) the activity of farming, forestry, ranching, horticulture, viticulture, or recreation, whether or not for profit, conducted on the land subject to the easement.

#### **Maximum benefit allowed**

The 50-percent exclusion from estate taxes for land subject to a qualified conservation easement (described above) could only be taken to the extent that the value of such land, plus the value of qualified family-owned business interests that qualify for the reduction in estate taxes (described in Part A., above), does not exceed \$5 million. The executor of an estate holding land subject to a qualified conservation easement and/or qualified family-owned business interests would be required to designate which of the two benefits was being claimed with respect to each property on which a benefit is claimed. To the extent that the aggregate value of such property exceeds \$5 million, such excess would be taxed at the regular estate tax rates.

#### **Treatment of land subject to a conservation easement for purposes of special-use valuation**

The proposal would amend the special-use valuation rules of present-law section 2032A in two respects. First, the granting of a qualified conservation easement (as defined above) would not be treated as a disposition triggering the recapture provisions of section 2032A. In addition, the proposal would provide that the existence of a qualified conservation easement would not prevent such property from subsequently qualifying for special-use valuation treatment under section 2032A.

#### **Effective Date**

The proposal would apply to decedents dying after December 31, 1995.

## **D. Modification of Generation-Skipping Transfer Tax for Transfers to Individuals with Deceased Parents**

### **Present Law**

A generation-skipping transfer tax ("GST" tax) generally is imposed on transfers, either directly or through a trust or similar arrangement, to a skip person (i.e., a beneficiary in more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions. For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (sec. 2612(c)(1)). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person (sec. 2612(a)). A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip)(sec. 2612(b)).

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

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

### **Description of Proposal**

The proposal would extend the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. For example, the exception would apply to a transfer made by an individual (with no living lineal heirs) to a grandniece where the transferor's nephew or niece who is the parent of the grandniece is deceased at the time of the transfer.

In addition, the proposal would extend the predeceased parent exception (as modified by the change in the preceding paragraph) to taxable terminations and taxable distributions, provided that the parent of the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiary's interest in the property was established) was subject to estate or gift tax. For example, where a trust was established to pay an annuity to a charity for a term for years with a remainder interest granted to a grandson, the termination of the term for years would not be a taxable

termination subject to the GST tax if the grandson's parent (who is the son or daughter of the transferor) was deceased at the time the trust was created and the transfer creating the trust was subject to estate or gift tax.

**Effective Date**

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

## **E. Estate Tax Recapture From Cash Leases of Specially-Valued Property**

### **Present Law**

A Federal estate tax is imposed on the value of property passing at death. Generally, such property is included in the decedent's estate at its fair market value. Under section 2032A, the executor may elect to value certain "qualified real property" used in farming or other qualifying trade or business at its current use value rather than its highest and best use. If, after the special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special-use valuation (sec. 2032A(c)).

Some courts have held that cash rental of specially-valued property after the death of the decedent is not a qualified use and, therefore, results in the imposition of the additional estate tax under section 2032A(c). See Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party); Williamson v. Commissioner, 93 T.C. 242 (1989), aff'd, 974 F.2d 1525 (9th Cir. 1992) (cash lease to family member); Fisher v. Commissioner, 65 T.C.M. 2284 (1993) (cash lease to family member).

With respect to a decedent's surviving spouse, a special rule provides that the surviving spouse will not be treated as failing to use the property in a qualified use solely because the spouse rents the property to a member of the spouse's family on a net cash basis. (sec. 2032A(b)(5)). Under section 2032A, members of an individual's family include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants.

### **Description of Proposal**

The proposal would provide that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, would not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c). No inference would be intended as to whether the cash lease of specially-valued real property is a qualified use of such property under present law.

### **Effective Date**

The proposal would be effective for cash rentals with respect to decedents dying after December 31, 1994.



## V. EXPIRING TAX PROVISIONS

### A. Provisions Extended Through February 28, 1997

#### 1. Work opportunity tax credit

##### Present and Prior Law

##### General rules

Prior to January 1, 1995, the targeted jobs tax credit was available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The credit generally was equal to 40 percent of qualified first-year wages. Qualified first-year wages consisted of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. For a vocational rehabilitation referral, however, the period began the day the individual began work for the employer on or after the beginning of the individual's vocational rehabilitation plan.

No more than \$6,000 of wages during the first year of employment were permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual was \$2,400.

With respect to economically disadvantaged summer youth employees, the credit was equal to 40 percent of up to \$3,000 of qualified first-year wages, for a maximum credit of \$1,200.

The deduction for wages was reduced by the amount of the credit.

##### Certification of members of targeted groups

In general, an individual was not treated as a member of a targeted group unless certification that the individual was a member of such a group was received or requested in writing by the employer from the designated local agency on or before the day on which the individual began work for the employer. In the case of a certification of an economically disadvantaged youth participating in a cooperative education program, this requirement was satisfied if the certification was requested or received from the participating school on or before the day on which the individual began work for the employer. The "designated local agency" was the State employment security agency.

If a certification was incorrect because it was based on false information provided as to the employee's membership in a targeted group, the certification was revoked. Wages paid after the revocation notice was received by the employer were not treated as qualified wages.

The U.S. Employment Service, in consultation with the Internal Revenue Service, was directed to take whatever steps necessary to keep employers informed of the availability of the credit.

### **Targeted groups eligible for the credit**

The nine groups eligible for the credit were either recipients of payments under means-tested transfer programs, economically disadvantaged (as measured by family income), or disabled individuals.

#### **(1) Vocational rehabilitation referrals**

Vocational rehabilitation referrals were those individuals who had a physical or mental disability that constituted a substantial handicap to employment and who had been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a State plan approved under the Rehabilitation Act of 1973, or under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification was provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee had met the above conditions.

#### **(2) Economically disadvantaged youths**

Economically disadvantaged youths were individuals certified by the designated local employment agency as (1) members of economically disadvantaged families and (2) at least age 18 but not age 23 on the date they were hired by the employer. An individual was determined to be a member of an economically disadvantaged family if, during the six months immediately preceding the earlier of the month in which the determination occurred or the month in which the hiring date occurred, the individual's family income was, on an annual basis, not more than 70 percent of the Bureau of Labor Statistics' lower living standard. A determination that an individual was a member of an economically disadvantaged family was valid for 45 days from the date on which the determination was made.

Except as otherwise noted below, a determination of whether an individual was a member of an economically disadvantaged family was made on the same basis and was subject to the same 45-day limitation, where required in connection with the four other targeted groups that excluded individuals who were not economically disadvantaged.

#### **(3) Economically disadvantaged Vietnam-era veterans**

The third targeted group was Vietnam-era veterans certified by the designated local employment agency as members of economically disadvantaged families. For these purposes, a Vietnam-era veteran was an individual who had served on active duty (other than for training) in

the Armed Forces for more than 180 days, or who had been discharged or released from active duty in the Armed Forces for a service-connected disability, but in either case, the active duty must have taken place after August 4, 1964, and before May 8, 1975. However, any individual who had served for a period of more than 90 days during which the individual was on active duty (other than for training) was not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule was intended to prevent employers who hired current members of the armed services (or those departed from service within the last 60-days) from receiving the credit.

(4) SSI recipients

The fourth targeted group was individuals receiving either Supplemental Security Income ("SSI") under Title XVI of the Social Security Act or State supplements described in section 1616 of that Act or section 212 of P.L. 93-66. To be an eligible employee, the individual must have received SSI payments during at least a one-month period ending during the 60-day period that ended on the date the individual was hired by the employer. The designated local agency was to issue the certification after a determination by the agency making the payments that these conditions had been fulfilled.

(5) General assistance recipients

General assistance recipients were individuals who received general assistance for a period of not less than 30 days if that period ended within the 60-day period ending on the date the individual was hired by the employer. General assistance programs were State and local programs that provided individuals with money payments, vouchers, or scrip based on need. These programs were referred to by a wide variety of names, including home relief, poor relief, temporary relief, and direct relief. Because of the wide variety of such programs, Congress provided that a recipient was an eligible employee only after the program had been designated by the Secretary of the Treasury as a program that provided money payments, vouchers, or scrip to needy individuals. Certification was performed by the designated local agency.

(6) Economically disadvantaged former convicts

The sixth targeted group included any individual who was certified by the designated local employment agency as (1) having at some time been convicted of a felony under State or Federal law, (2) being a member of an economically disadvantaged family, and (3) having been hired within five years of the later of release from prison or date of conviction.

(7) Economically disadvantaged cooperative education students

The seventh targeted group was youths who (1) actively participated in qualified cooperative education programs, (2) had attained age 16 but had not attained age 20, (3) had not graduated from high school or vocational school, and (4) were members of economically

disadvantaged families. The definitions of a qualified cooperative education program and a qualified school were similar to those used in the Vocational Education Act of 1963. Thus, a qualified cooperative education program meant a program of vocational education for individuals who, through written cooperative arrangements between a qualified school and one or more employers, received instruction, including required academic instruction, by alternation of study in school with a job in any occupational field, but only if these two experiences were planned and supervised by the school and the employer so that each experience contributed to the student's education and employability.

For this purpose, a qualified school was (1) a specialized high school used exclusively or principally for the provision of vocational education to individuals who were available for study in preparation for entering the labor market, (2) the department of a high school used exclusively or principally for providing vocational education to individuals who were available for study in preparation for entering the labor market, or (3) a technical or vocational school used exclusively or principally for the provision of vocational education to individuals who had completed or left high school and who were available for study in preparation for entering the labor market. In order for a nonpublic school to be a qualified school, it must have been exempt from income tax under section 501(a) of the Code.

The certification was performed by the school participating in the cooperative education program. After initial certification, an individual remained a member of the targeted group only while meeting the program participation, age, and degree status requirements of (a), (b), and (c), above.

(8) AFDC recipients

The eighth targeted group included any individual who was certified by the designated local employment agency as being eligible for Aid to Families with Dependent Children ("AFDC") and as having continually received such aid during the 90 days before being hired by the employer.

(9) Economically disadvantaged summer youth employees

The ninth targeted group included youths who performed services during any 90-day period between May 1 and September 15 of a given year and who were certified by the designated local agency as (1) being 16 or 17 years of age on the hiring date and (2) a member of an economically disadvantaged family. A youth must not have been an employee of the employer prior to that 90-day period. With respect to any particular employer, an employee could qualify only one time for this summer youth credit. If, after the end of the 90-day period, the employer continued to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages took into account wages paid to the youth while a qualified summer youth employee.

## **Definition of wages**

In general, wages eligible for the credit were defined by reference to the definition of wages under the Federal Unemployment Tax Act (FUTA). Because wages paid to economically disadvantaged cooperative education students and to certain agricultural and railroad employees were not FUTA wages, special rules were provided for these wages.

Wages were taken into account for purposes of the credit only if more than one-half of the wages paid during the taxable year to an employee were for services in the employer's business. The test as to whether more than one-half of an employee's wages were for services in a business was applied to each separate employer in a controlled group.

## **Other rules**

In order to prevent taxpayers from eliminating all tax liability by reason of the credit, the amount of the credit could not exceed 90 percent of the taxpayer's income tax liability. Furthermore, the credit was allowed only after certain other nonrefundable credits had been taken. If, after applying these other credits, 90 percent of an employer's remaining tax liability for the year was less than the targeted jobs tax credit, the excess credit could be carried back three years and carried forward 15 years.

All employees of all corporations in a controlled group of corporations were treated as if they were employed by one corporation for purposes of determining the years of employment and the \$6,000 wage limit. Generally, under the controlled group rules, the credit allowed the group was the same as if the group were a single company. A comparable rule was provided in the case of partnerships, sole proprietorships, and other trades or businesses (whether or not incorporated) that were under common control.

No credit was available for the hiring of related individuals (primarily dependents or owners of the taxpayer).

No credit was allowed for wages paid unless the eligible individual was either (1) employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees) or (2) had completed at least 120 hours (20 hours for summer youth) of services performed for the employer.

## **Description of Proposal**

### **General rules**

The proposal would replace the targeted jobs tax credit with the "work opportunity tax credit." The work opportunity tax credit would be available on an elective basis for employers hiring individuals from one or more of six targeted groups. The credit generally would be

available equal to 35 percent of qualified wages. Qualified wages would consist of wages earned by a member of a targeted group during the one-year period beginning with the day the individual begins work. For a vocational rehabilitation referral the period would begin on the day the individual began work for the employer on or after the beginning of the individual's vocational rehabilitation plan.

No more than \$6,000 of wages during the first year of employment would be allowed for the credit. Thus, the maximum credit per worker would be \$2,100.

With respect to qualified summer youth employees, the maximum credit would be \$1050.

Employers would have to reduce the deduction for wages paid by the amount of the credit.

### **Certification of members of targeted groups**

An individual would not be treated as a member of a targeted group unless: (1) on or before the day the individual begins work, the employer received a written 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, a pre-screening notice is completed by the employer. The notice must be filed with the State agency within 14 days after the individual begins work. The pre-screening notice would contain the information necessary to determine whether the individual is a member of a targeted group.

If a certification is based on false information, the certification would be revoked. No credit would be allowed on wages paid after receipt by the employer of the revocation notice.

A designated local agency that rejects a certification request would have to provide a written explanation of that rejection.

### **Targeted groups eligible for the credit**

#### **(1) Families receiving cash welfare benefits**

An eligible recipient would be an individual certified as receiving cash welfare benefits under a Federally funded program (AFDC or successor programs) for a period of at least nine months part of which is during the 9-month period ending on the hiring date. For these purposes, each member of the family receiving such assistance would be treated as receiving such assistance.

(2) Qualified ex-felon

A qualified ex-felon would be an individual certified as: (1) having been convicted of a felony under any State or Federal law; (2) being a member of a family which had an income during the six months before the earlier of the date of determination or the hiring date which on an annual basis is 70 percent or less of the Bureau of Labor Statistics lower living standard; and (3) having a hiring date within one year of release from prison or date of conviction.

(3) High-risk-youth

A high-risk youth would be an individual certified as being at least 18 but not 25 on the hiring date and as having a principal place of abode within an empowerment zone or enterprise community. Qualified wages would not include wages paid or incurred for services performed after the individual moves outside an empowerment zone or enterprise community.

(4) Vocational rehabilitation referral

Vocational rehabilitation referrals would be those individuals who have physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a Federally approved State plan. Certification would be provided by the designated State employment agency after assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(5) Qualified summer youth employee

Qualified summer youth employees would be individuals: (1) who perform services during any 90-day period between May 1 and September 15; (2) who are certified by the designated State agency as being 16 or 17 years of age on the hiring date; (3) who have not been an employee of that employer before; and (4) who are certified by the designated local agency as having a principal place of abode within an empowerment zone or enterprise community. No credit would be available on wages earned for service performed after the qualified summer youth moves outside of an empowerment zone or enterprise community. If, after the end of the 90-day period, the employer continued to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages would take into account wages paid to the youth while a qualified summer youth employee.

(6) Qualified Veterans

A qualified veteran would be a veteran who has been certified as receiving assistance under: (1) a Federally funded program of cash welfare benefits (AFDC or successor program) for a period of at least nine months part of which is during the 12-month period ending on the

hiring date, or (2) the Food Stamp Program under the Food Stamp Act of 1977, for a period of at least three months part of which is during the 12-month period ending on the hiring date.

Further, a qualified veteran would be an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days, or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

### **Definition of wages and other rules**

In general, wages eligible for the credit would be defined by reference to the definition of wages under the Federal Unemployment Tax Act ("FUTA"). Also, the other prior-law rules are generally still applicable.

### **Minimum employment period**

No credit would be allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 400 hours (120 hours in the case of a qualified summer youth employee).

### **Business awareness program**

The Secretary of Labor would establish a program to encourage small businesses to work with the designated local agencies to identify eligible individuals for inclusion in the credit program. The Secretary and heads of other Federal agencies also would be directed to simplify credit procedures to encourage participation.

### **Effective Date**

The credit would be effective for wages paid or incurred to qualified individuals who begin work on or after January 1, 1996, and before March 1, 1997.

## **2. Employer-provided educational assistance**

### **Present and Prior Law**

For taxable years beginning after December 31, 1994, an employee must include in income and wages, for income and employment tax purposes, the value of educational assistance provided by an employer to an employee, unless the cost of such assistance qualifies as a deductible job-



related expense of the employee. Amounts expended for education qualify as deductible job-related expenses if the education (1) maintains or improves skills required for the employee's current job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of continued employment in the employee's current job (Treas. Reg. sec. 1.162-5(a)). Such expenses (if not reimbursed by the employer) are deductible only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed 2 percent of the taxpayer's adjusted gross income. No deduction (or exclusion) is allowed for expenses incurred to qualify for a new trade or business.

For taxable years beginning before January 1, 1995, an employee's gross income and wages did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements. This exclusion, which expired for taxable years beginning after December 31, 1994, was limited to \$5,250 of educational assistance with respect to an individual during a calendar year. The exclusion applied whether or not the education was job related.

#### **Description of Proposal**

The proposal would extend the exclusion for educational assistance for taxable years beginning after December 31, 1994, and before January 1, 1998. In the case of a taxable year beginning in 1997, the maximum amount that could be excluded would be one-sixth of \$5,250 or \$875, and only amounts paid by the employer before March 1, 1997, would be taken into account.

#### **Effective Date**

The proposal would be effective with respect to taxable years beginning after December 31, 1994, and before January 1, 1998.

### **3. Research and experimentation tax credit**

#### **Present and Prior Law**

##### **General rule**

Prior to July 1, 1995, section 41 of the Internal Revenue Code provided 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 does not apply to amounts paid or incurred after June 30, 1995.

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.<sup>1</sup>

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, research expenditures and gross receipts of the taxpayer are aggregated with research expenditures and gross receipts of certain related persons for purposes of computing any allowable credit (sec. 41(f)(1)). Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change or ownership of a trade or

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<sup>1</sup> The Omnibus Budget Reconciliation Act of 1993 included a special rule 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 (i.e., any taxpayer that did not have gross receipts in at least three years during the 1984-1988 period) 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 June 30, 1995 expiration date, a start-up firm's fixed-base 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-base percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

### **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").

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) 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. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control (sec. 41(d)(4)).

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**

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized. However, 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 (including the university basic research credit) would be extended for the period July 1, 1995, through February 28, 1997.

In addition, the proposal would expand the definition of "start-up firms" under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.

### **Effective Date**

The proposal would be effective for expenditures paid or incurred during the period July 1, 1995, through February 28, 1997.

#### **4. Exclusion for employer-provided group legal services; tax exemption for qualified group legal services organizations**

### **Prior Law**

Under prior law, employees were not subject to income or employment tax on amounts contributed by an employer to a qualified group legal services plan. The exclusion did not apply to the extent that the value of insurance against legal costs incurred by the individual (or spouse or dependents) provided under the plan exceeded \$70. The exclusion for group legal services benefits expired after June 30, 1992.

In addition, prior law provided tax-exempt status for an organization the exclusive function of which was to provide legal services or indemnification against the cost of legal services provided through a qualified group legal services plan. The tax exemption for such an organization expired for taxable years beginning after June 30, 1992.

### **Description of Proposal**

The proposal would extend the exclusion from income for contributions to employer-provided group legal services plans and the exemption from tax for certain group legal services organizations from January 1, 1996, through February 28, 1997. The exclusion would be available with respect to contributions to employer-provided group legal services plans through February 28, 1997, but the limit on the value of insurance provided under the plan for taxable years beginning in 1997 would be one-sixth of \$70 or \$12.

### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 1995, and before February 28, 1997.

## 5. Orphan drug tax credit

### Present and Prior Law

Prior to January 1, 1995, a 50-percent nonrefundable tax credit was allowed for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." Qualified testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration (FDA) but before the drug has been approved for sale by the FDA. A rare disease or condition is defined as one that (1) affects less than 200,000 persons in the United States or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for it from U.S. sales of the drug. These rare diseases and conditions include Huntington's disease, myoclonus, ALS (Lou Gehrig's disease), Tourette's syndrome, and Duchenne's dystrophy (a form of muscular dystrophy).

Under prior law, the orphan drug tax credit could be claimed by a taxpayer only to the extent that its regular tax liability for the year the credit was earned exceeded its tentative minimum tax for that year, after regular tax was reduced by nonrefundable personal credits and the foreign tax credit.<sup>2</sup> Unused credits could not be carried back or carried forward to reduce taxes in other years.

The orphan drug tax credit expired after December 31, 1994.

### Description of Proposal

The orphan drug tax credit would be extended for the period January 1, 1995, through February 28, 1997.

In addition, taxpayers would be allowed to carry back unused credits to three years preceding the year the credit was earned and to carry forward unused credits to 15 years following the year the credit was earned.

### Effective Date

The proposal would be effective for qualified clinical testing expenses incurred during the period January 1, 1995, through February 28, 1997. Credits could not be carried back to a taxable year beginning before January 1, 1995.

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<sup>2</sup> To the extent that the orphan drug tax credit could not be used by reason of the minimum tax limitation, the taxpayer's minimum tax credit was increased (sec. 53(d)(1)(B)(iii)).

## 6. Contributions of appreciated stock to private foundations

### Present and Prior 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.<sup>3</sup> 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.<sup>4</sup>

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 were allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to January 1, 1995. Qualified appreciated stock was defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applied 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 was treated as making all contributions that were made by any member of the individual's family. This special rule contained in section 170(e)(5) expired after December 31, 1994.

### Description of Proposal

The special rule contained in section 170(e)(5) for contributions of qualified appreciated stock made to private foundations would be extended for contributions made during the period January 1, 1995, through February 28, 1997.

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<sup>3</sup> 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)).

<sup>4</sup> As part of the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, if a taxpayer makes a gift to charity of property (other than short-term gain, inventory, or other ordinary income property, or gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim the same fair-market-value deduction for both regular tax and AMT purposes (subject to present-law percentage limitations).

### **Effective Date**

The proposal would be effective for contributions of qualified appreciated stock to private foundations made during the period January 1, 1995, through February 28, 1997.

## **7. Transportation fuels tax exemption for fuel used in commercial aviation**

### **Present law**

A 4.3-cents-per-gallon deficit reduction excise tax is imposed on fuel used in most transportation modes. Fuels subject to the tax include gasoline (including gasoline blended with alcohol, "gasohol"), diesel fuel, special motor fuels, propane, compressed natural gas, aviation fuels (jet fuel and gasoline), and any other motor fuel used in shipping in the inland waterway system. Fuel consumed before October 1, 1995, in commercial aviation, defined as the air transportation of persons or property for hire, was exempt from this tax. Revenues from this transportation fuels tax are deposited in the General Fund of the Treasury.

### **Description of Proposal**

The present exemption for commercial aviation fuels would be extended for through February 28, 1997. Thereafter, the full 4.3-cents-per-gallon tax would be imposed.

### **Effective Date**

The proposal generally would be effective after September 30, 1995.

Under present law, this excise tax is imposed on transactions occurring after September 30, 1995, and the floor stocks tax imposed by the Omnibus Budget Reconciliation Act of 1993 was imposed on October 1, 1995. Therefore, the proposal would provide refunds to commercial aviation users for any such taxes paid before its enactment upon adequate documentation that tax-paid fuel was purchased. A further expression of the Committee's desire that the Internal Revenue Service consider waiving the semimonthly deposit requirements for this tax during the period beginning on October 1, 1995, and ending on the date on which 1995 budget reconciliation process is completed would be included in the legislative history accompanying the proposal.

Appropriate floor stocks taxes would be imposed on March 1, 1997.

## **8. Suspend imposition of diesel fuel tax on motorboats**

### **Present Law**

An excise tax totaling 24.4 cents per gallon is imposed on diesel fuel. The Omnibus Budget Reconciliation Act of 1993 extended this tax to diesel fuel used in recreational motorboats,

effective through December 31, 1999. The tax on diesel fuel used in motorboats was enacted as a revenue offset for repeal of the luxury excise tax on certain boats.

The diesel fuel tax is imposed on removal of the fuel from a registered terminal facility (i.e., at the "terminal rack"). Present law provides that tax is imposed on all diesel fuel removed from terminal facilities unless the fuel is destined for a nontaxable use and is indelibly dyed pursuant to Treasury Department regulations. If fuel on which tax is paid at the terminal rack (i.e., undyed diesel fuel) ultimately is used in a nontaxable use, a refund is allowed. Depending on the aggregate amount of tax to be refunded, this refund may be claimed either by a direct filing with the Internal Revenue Service or as a credit against income tax.

Dyed diesel fuel (fuel on which no tax is paid) may not be used in a taxable use. Present law imposes a penalty equal to the greater of \$10 per gallon or \$1,000 on persons found to be violating this prohibition.

### **Description of Proposal**

No tax would be imposed on diesel fuel used in recreational motorboats during the period January 1, 1996, through February 28, 1997.

This exemption would temporarily address current supply problems. In an attempt to find a permanent solution that protects tax collection and avoids supply disruptions, the legislative history accompanying the proposal would request the Treasury Department to study possible alternatives to the current collection regime for motorboat diesel fuel that would provide comparable compliance with the law, and to report to the Committee on Ways and Means and the Committee on Finance no later than June 30, 1996.

### **Effective Date**

The proposal would be effective after December 31, 1995.



## **B. Extend Expired Ethanol Blender Refund Provision**

### **Present Law**

A 54-cents-per-gallon blender income tax credit is provided for ethanol used as a motor fuel. This credit applies to ethanol which is blended with gasoline ("gasohol").

Gasoline is subject to an 18.4-cents-per-gallon excise tax. As an alternative to claiming the income tax credit gasohol blenders may claim the benefit of the ethanol income tax credit against their gasoline excise tax liability. The benefit may be claimed against excise tax liability in either of two ways: (1) by purchasing gasoline destined for blending with ethanol at a reduced excise tax rate, or (2) before October 1, 1995, by claiming expedited refunds of excise tax paid on gasoline purchased at the full 18.4-cents-per-gallon rate after that gasoline is blended with ethanol. In general, the gasoline (including gasohol) excise tax provisions associated with the Highway Trust Fund expire after September 30, 1999.

### **Description of Proposal**

The proposal would conform the expiration date for the excise tax expedited refund provision for gasohol blenders that expired after September 30, 1995, to that for gasoline tax provisions generally. Thus, these refunds would be permitted through September 30, 1999.

For refund claims that could have been filed during the period beginning on October 8, 1995 and ending on the date of enactment, but for expiration of the refund provision after September 30, 1995, interest would accrue from the date which is the later of (1) November 1, 1995, or (2) 20 days after the claim could have been filed under the law as in effect on September 30, 1995.

### **Effective Date**

The proposal would be effective on enactment.

## **C. Exempt Alaska from Diesel Dyeing Requirement While Alaska is Exempt From Similar Clean Air Act Dyeing**

### **Present Law**

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

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

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

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

### **Description of Proposal**

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

### **Effective Date**

The proposal would be effective as if included in the Omnibus Budget Reconciliation Act of 1993.

## **D. Tax Credit for Producing Fuel From a Nonconventional Source**

### **Present Law**

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

- (1) oil produced from shale and tar sands;
- (2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and
- (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993, expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before January 1, 1997, pursuant to a binding written contract in effect before January 1, 1996.

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

### **Description of Proposal**

The placed-in-service (and binding contract) dates for facilities producing synthetic fuels from coal and gas from biomass would be extended for one year. The present sunset on production qualifying for the credit would not be changed. Under the proposal, fuel produced from a facility placed in service before January 1, 1998, pursuant to a binding contract entered into before January 1, 1997, would be eligible for the tax credit if produced before January 1, 2008.

### **Effective Date**

The proposal would be effective upon enactment.

## **E. Superfund and Oil Spill Liability Taxes**

### **1. Extend Superfund excise taxes and corporate environmental income tax**

#### **Present Law**

Four different Superfund taxes are imposed under present law. These are:

- (1) An excise tax on petroleum, imposed at a rate of 9.7 cents per barrel, on domestic or imported crude oil or refined products;
- (2) An excise tax on listed hazardous chemicals, imposed at a rate that varies from \$0.22 to \$4.87 per ton;
- (3) An excise tax on imported substances that use as materials in their manufacture or production one or more of the hazardous chemicals subject to the excise tax described in (2), above;
- (4) A corporate environmental income tax equal to 0.12 percent of the amount of modified alternative minimum taxable income of a corporation that exceeds \$2 million.

Modified alternative minimum taxable income is defined as a corporation's alternative minimum taxable income, but determined without regard to the alternative tax net operating loss deduction and the deduction for the corporate environmental income tax (sec. 59A).

Amounts equivalent to the revenues from these taxes are dedicated to the Hazardous Substance Superfund Trust Fund ("Superfund Trust Fund"), established in the Trust Fund Code of the Internal Revenue Code. Amounts in the Superfund Trust Fund generally are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended).

The Superfund taxes are scheduled to expire after December 31, 1995. However, the taxes would have terminated earlier if either (1) the obligated balance in the Superfund Trust Fund exceeded \$3.5 billion on December 31, 1994, and the Treasury Department estimated that the unobligated balance would exceed \$3.5 billion at the end of 1995 (assuming no Superfund taxes had been imposed during 1995), or (2) the Treasury Department had estimated that more than \$11.97 billion of revenues from these taxes would have been credited into the Superfund Trust Fund before January 1, 1996.

### **Description of Proposal**

The present-law Superfund excise taxes on petroleum, chemicals, and imported substances would be extended through September 30, 2002. The corporate environmental income tax would be extended through December 31, 1997.

The provisions terminating the Superfund taxes if either the unobligated balance in the Superfund exceeds \$3.5 billion before a specified date or if aggregate tax collections exceed \$11.97 billion would be repealed.

### **Effective Date**

The proposal would be effective on enactment.

## **2. Extend Oil Spill Liability Trust Fund excise tax**

### **Present Law**

A 5-cents-per-barrel excise tax was imposed on crude oil received at United States refineries and refined petroleum products imported into the United States before January 1, 1995. Revenues from this tax were dedicated to the Oil Spill Liability Trust Fund ("Oil Spill Trust Fund"). In addition to the January 1, 1995, expiration date, imposition of this tax was suspended during any calendar quarter (before 1995) when the unobligated balance of the Oil Spill Trust Fund, as of the close of the preceding quarter, exceeded \$1 billion.

### **Description of Proposal**

The 5-cents-per-barrel excise tax would be reimposed during the period January 1, 1996, through September 30, 2002. The \$1 billion unobligated balance limit on the Oil Spill Trust Fund would be retained.

### **Effective Date**

The proposal would be effective after December 31, 1995.

## F. Expatriation Tax Provisions

### Present Law

#### a. Taxation of United States citizens, residents, and nonresidents

##### Individual income taxation

##### Income taxation of U.S. citizens and residents

In general.--A United States citizen generally is subject to the U.S. individual income tax on his or her worldwide taxable income. All income earned by a U.S. citizen, from sources inside and outside the United States, is taxable, whether or not the individual lives within the United States. A non-U.S. citizen who resides in the United States generally is taxed in the same manner as a U.S. citizen if the individual meets the definition of a "resident alien," described below.

The taxable income of a U.S. citizen or resident is equal to the taxpayer's total income less certain exclusions, exemptions, and deductions. The appropriate tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. A taxpayer may reduce his or her income tax liability by any applicable tax credits. When an individual disposes of property, any gain or loss on the disposition is determined by reference to the taxpayer's cost basis in the property, regardless of whether the property was acquired during the period in which the taxpayer was a citizen or resident of the United States.

If a U.S. citizen or resident earns income from sources outside the United States, and that income is subject to foreign income taxes, the individual generally is permitted a foreign tax credit against his or her U.S. income tax liability to the extent of foreign income taxes paid on that income.<sup>5</sup> In addition, a United States citizen who lives and works in a foreign country generally is permitted to exclude up to \$70,000 of annual compensation from being subject to U.S. income taxes, and is permitted an exclusion or deduction for certain housing expenses.<sup>6</sup>

Resident aliens.--In general, a non-U.S. citizen is considered a resident of the United States if the individual (1) has entered the United States as a lawful permanent U.S. resident (the "green card test"); or (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time--183 or

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<sup>5</sup> See sections 901-907.

<sup>6</sup> Section 911.

more days during a 3-year period weighted toward the present year (the "substantial presence test").<sup>7</sup>

If an individual is present in the United States for fewer than 183 days during the calendar year, and if the individual establishes that he or she has a closer connection with a foreign country than with the United States and has a tax home in that country for the year, the individual generally is not subject to U.S. tax as a resident on account of the substantial presence test. If an individual is present for as many as 183 days during a calendar year, this closer connections/tax home exception is not available. An alien who has an application pending to change his or her status to permanent resident or who has taken other steps to apply for status as a lawful permanent U.S. resident is not eligible for the closer connections/tax home exception.

For purposes of applying the substantial presence test, any days that an individual is present as an "exempt individual" are not counted. Exempt individuals include certain foreign government-related individuals, teachers, trainees, students, and professional athletes temporarily in the United States to compete in charitable sports events. In addition, the substantial presence test does not count days of presence of an individual who is physically unable to leave the United States because of a medical condition that arose while he or she was present in the United States, if the individual can establish to the satisfaction of the Secretary of the Treasury that he or she qualifies for this special medical exception.

In some circumstances, an individual who meets the definition of a U.S. resident (as described above) could also be defined as a resident of another country under the internal laws of that country. In order to avoid the double taxation of such individuals, most income tax treaties include a set of "tie-breaker" rules to determine the individual's country of residence for income tax purposes. In general, a dual resident is deemed to be a resident of the country in which such person has a permanent home. If the individual has a permanent home available in both countries, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (i.e., the "center of vital interests.") If the country in which such individual has his or her center of vital interests cannot be determined, or if such individual does not have a permanent home available in either country, he or she is deemed to be a resident of the country in which he or she has an habitual abode. If the individual has an habitual abode in both countries or in neither country, he or she is deemed to be a resident of the country of which he or she is a citizen. If each country considers the person to be its citizen or if he or she is a citizen of neither country, the competent authorities of the countries are to settle the question of residence by mutual agreement.

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<sup>7</sup> The definitions of resident and nonresident aliens are set forth in section 7701(b). The substantial presence test will compare 183 days to the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year. Presence for 122 days (or more) per year over the 3-year period would constitute substantial presence under the test.

## **Income taxation of nonresident aliens**

Non-U.S. citizens who do not meet the definition of "resident aliens" are considered to be nonresident aliens for tax purposes. Nonresident aliens are subject to U.S. tax only to the extent their income is from U.S. sources or is effectively connected with the conduct of a trade or business within the United States. Bilateral income tax treaties may modify the U.S. taxation of a nonresident alien.

A nonresident alien is taxed at regular graduated rates on net profits derived from a U.S. business.<sup>8</sup> Nonresident aliens also are taxed at a flat rate of 30 percent on certain types of passive income derived from U.S. sources, although a lower rate may be provided by treaty (e.g., dividends are frequently taxed at a reduced rate of 15 percent). Such passive income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income. There is no U.S. tax imposed, however, on interest earned by nonresident aliens with respect to deposits with U.S. banks and certain types of portfolio debt investments.<sup>9</sup> Gains on the sale of stocks or securities issued by U.S. persons generally are not taxable to a nonresident alien because they are considered to be foreign source income.<sup>10</sup>

Nonresident aliens are subject to U.S. income taxation on any gain recognized on the disposition of an interest in U.S. real property.<sup>11</sup> Such gains generally are subject to tax at the same rates that apply to similar income received by U.S. persons. If a U.S. real property interest is acquired from a foreign person, the purchaser generally is required to withhold 10 percent of the amount realized (gross sales price). Alternatively, either party may request that the Internal

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<sup>8</sup> Section 871.

<sup>9</sup> See sections 871(h) and 871(i)(3).

<sup>10</sup> Section 865(a).

<sup>11</sup> Sections 897, 1445, 6039C, and 6652(f), known as the Foreign Investment in Real Property Tax Act ("FIRPTA"). Under the FIRPTA provisions, tax is imposed on gains from the disposition of an interest (other than an interest solely as a creditor) in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). A USRPHC is any corporation, the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)).



Revenue Service ("IRS") determine the transferor's maximum tax liability and issue a certificate prescribing a reduced amount of withholding (not to exceed the transferor's maximum tax liability).<sup>12</sup>

### **Estate and gift taxation**

The United States imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident,<sup>13</sup> whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. No gift tax is imposed, however, on gifts made by nonresident aliens of intangible property having a situs within the United States (e.g., stocks and bonds).<sup>14</sup>

The United States also imposes an estate tax on the worldwide "gross estate" of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death.<sup>15</sup>

Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a U.S. citizen or resident during his or her lifetime and at death. Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over \$3 million.<sup>16</sup> A unified credit of \$192,800 is available with respect to taxable transfers by gift and at death. The unified credit effectively exempts a total of \$600,000 in cumulative taxable transfers from the estate and gift tax.

Residency for purposes of estate and gift taxation is determined under different rules than those applicable for income tax purposes. In general, an individual is considered to be a resident of the United States for estate and gift tax purposes if the individual is "domiciled" in the United States. An individual is domiciled in the United States if the individual (a) is living in the United States and has the intention to remain in the United States indefinitely; or (b) has lived in the United States with such an intention and has not formed the intention to remain indefinitely in another country. In the case of a U.S. citizen who resided in a U.S. possession at the time of

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<sup>12</sup> Section 1445.

<sup>13</sup> Section 2501.

<sup>14</sup> Section 2501(a)(2).

<sup>15</sup> Sections 2001, 2031, 2101, and 2103.

<sup>16</sup> Section 2001(c).

death, if the individual acquired U.S. citizenship solely on account of his or her birth or residence in a U.S. possession, that individual is not treated as a U.S. citizen or resident for estate tax purposes.<sup>17</sup>

In addition to the estate and gift taxes, a separate transfer tax is imposed on certain "generation-skipping" transfers.

### **Special tax rules with respect to the movement of persons into or out of the United States**

#### **Individuals who relinquish U.S. citizenship with a principal purpose of avoiding U.S. tax**

An individual who relinquishes his or her U.S. citizenship with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for 10 years after expatriation under section 877.<sup>18</sup> Under this provision, if the Treasury Department establishes that it is reasonable to believe that the expatriate's loss of U.S. citizenship would, but for the application of this provision, result in a substantial reduction in U.S. tax based on the expatriate's probable income for the taxable year, then the expatriate has the burden of proving that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. Section 877 does not apply to resident aliens who terminate their U.S. residency.

The alternative method modifies the rules generally applicable to the taxation of nonresident aliens in two ways. First, the expatriate is subject to tax on his or her U.S. source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident aliens. (Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on any foreign source income.) Second, the scope of items treated as U.S. source income for section 877 purposes is broader than those items generally considered to be U.S. source income under the Code. For example, gains on the sale of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S. source income under the Code. However, if an individual is subject to the alternative taxing method of section 877, such gains are treated as U.S. source income with respect to that individual. The alternative method applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident alien.

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<sup>17</sup> Section 2209.

<sup>18</sup> Treasury regulations provide that an individual's citizenship status is governed by the provisions of the Immigration and Nationality Act, specifically referring to the "rules governing loss of citizenship [set forth in] sections 349 to 357, inclusive, of such Act (8 U.S.C. 1481-1489)." Treas. Reg. section 1.1-1(c). Under the Immigration and Nationality Act, an individual is generally considered to lose U.S. citizenship on the date that an expatriating act is committed. The present-law rules governing the loss of citizenship, and a description of the types of expatriating acts that lead to a loss of citizenship, are discussed more fully below.

Because section 877 alters the sourcing rules generally used to determine the country having primary taxing jurisdiction over certain items of income, there is an increased potential for such items to be subject to double taxation. For example, a former U.S. citizen subject to the section 877 rules may have capital gains derived from stock in a U.S. corporation. Under section 877, such gains are treated as U.S. source income, and are, therefore, subject to U.S. tax. Under the internal laws of the individual's new country of residence, however, that country may provide that all capital gains realized by a resident of that country are subject to taxation in that country, and thus the individual's gain from the sale of U.S. stock also would be taxable in his or her country of residence. If the individual's new country of residence has an income tax treaty with the United States, the treaty may provide for the amelioration of this potential double tax.

Similar rules apply in the context of estate and gift taxation if the transferor relinquished U.S. citizenship with a principal purpose of avoiding U.S. taxes within the 10-year period ending on the date of the transfer. A special rule is applied to the estate tax treatment of any decedent who relinquished his or her U.S. citizenship within 10 years of death, if the decedent's loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive.<sup>19</sup> Once the Secretary of the Treasury establishes a reasonable belief that the expatriate's loss of U.S. citizenship would result in a substantial reduction in estate, inheritance, legacy and succession taxes, the burden of proving that one of the principal purposes of the loss of U.S. citizenship was not avoidance of U.S. income or estate tax is on the executor of the decedent's estate.

In general, the estates of individuals who have relinquished U.S. citizenship are taxed in accordance with the rules generally applicable to the estates of nonresident aliens (i.e., the gross estate includes all U.S.-situs property held by the decedent at death, is subject to U.S. estate tax at the rates generally applicable to the estates of U.S. citizens, and is allowed a unified credit of \$13,000, as well as credits for State death taxes, gift taxes, and prior transfers). However, a special rule provides that the individual's gross estate also includes his or her pro-rata share of any U.S.-situs property held through a foreign corporation in which the decedent had a 10-percent or greater voting interest, provided that the decedent and related parties together owned more than 50 percent of the voting power of the corporation. Similarly, gifts of intangible property having a situs within the United States (e.g., stocks and bonds) made by a nonresident alien who relinquished his or her U.S. citizenship within the 10-year period ending on the date of transfer are subject to U.S. gift tax, if the loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive.<sup>20</sup>

#### **Aliens having a break in residency status**

A special rule applies in the case of an individual who has been treated as a resident of the United States for at least three consecutive years, if the individual becomes a nonresident but

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<sup>19</sup> Section 2107.

<sup>20</sup> Section 2501(a)(3).

regains residency status within a three-year period.<sup>21</sup> In such cases, the individual is subject to U.S. tax for all intermediate years under the section 877 rules described above (i.e., the individual is taxed in the same manner as a U.S. citizen who renounced U.S. citizenship with a principal purpose of avoiding U.S. taxes). The special rule for a break in residency status applies regardless of the subjective intent of the individual.

## **b. Requirements for United States citizenship, immigration, and visas**

### **United States citizenship**

An individual may acquire U.S. citizenship in one of three ways: (1) being born within the geographical boundaries of the United States; (2) being born outside the United States to at least one U.S. citizen parent (as long as that parent had previously been resident in the United States for a requisite period of time); or (3) through the naturalization process. All U.S. citizens are required to pay U.S. income taxes on their worldwide income. The State Department estimates that there are approximately 3 million U.S. citizens living abroad, although thousands of these individuals may not even know that they are U.S. citizens.

A U.S. citizen may voluntarily give up his or her U.S. citizenship at any time by performing one of the following acts ("expatriating acts") with the intention of relinquishing U.S. nationality: (1) becoming naturalized in another country; (2) formally declaring allegiance to another country; (3) serving in a foreign army; (4) serving in certain types of foreign government employment; (5) making a formal renunciation of nationality before a U.S. diplomatic or consular officer in a foreign country; (6) making a formal renunciation of nationality in the United States during a time of war; or (7) committing an act of treason.<sup>22</sup> An individual who wishes formally to renounce citizenship (item (5), above) must execute an Oath of Renunciation before a consular officer, and the individual's loss of citizenship is effective on the date the oath is executed. In all other cases, the loss of citizenship is effective on the date that the expatriating act is committed, even though the loss may not be documented until a later date. The State Department generally documents loss in such cases when the individual acknowledges to a consular officer that the act was taken with the requisite intent. In all cases, the consular officer abroad submits a certificate of loss of nationality ("CLN") to the State Department in Washington, D.C. for approval.<sup>23</sup> Upon approval, a copy of the CLN is issued to the affected individual.

Before a CLN is issued, the State Department reviews the individual's files to confirm that: (1) the individual was a U.S. citizen; (2) an expatriating act was committed; (3) the act was undertaken voluntarily; and (4) the individual had the intent of relinquishing citizenship when the

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<sup>21</sup> Section 7701(b)(10).

<sup>22</sup> 8 U.S.C. section 1481.

<sup>23</sup> 8 U.S.C. section 1501.

expatriating act was committed. If the expatriating act involved an action of a foreign government (for example, if the individual was naturalized in a foreign country or joined a foreign army), the State Department will not issue a CLN until it has obtained an official statement from the foreign government confirming the expatriating act. If a CLN is not issued because the State Department does not believe that an expatriating act has occurred (for example, if the requisite intent appears to be lacking), the issue is likely to be resolved through litigation. Whenever the loss of U.S. nationality is put in issue, the burden of proof is on the person or party claiming that a loss of citizenship has occurred to establish, by a preponderance of the evidence, that the loss occurred.<sup>24</sup> Similarly, if a CLN has been issued, but the State Department later discovers that such issuance was improper (for example, because fraudulent documentation was submitted, or the requisite intent appears to be lacking), the State Department could initiate proceedings to revoke the CLN. If the recipient is unable to establish beyond a preponderance of the evidence that citizenship was lost on the date claimed, the CLN would be revoked. To the extent that the IRS believes a CLN was improperly issued, the IRS could present such evidence to the State Department and request that revocation proceedings be commenced. If it is determined that the individual has indeed committed an expatriating act, the date for loss of citizenship will be the date of the expatriating act.

A child under the age of 18 cannot lose U.S. citizenship by naturalizing in a foreign state or by taking an oath of allegiance to a foreign state. A child under 18 can, however, lose U.S. citizenship by serving in a foreign military or by formally renouncing citizenship, but such individuals may regain their citizenship by asserting a claim of citizenship before reaching the age of eighteen years and six months.

A naturalized U.S. citizen can have his or her citizenship involuntarily revoked if a U.S. court determines that the certificate of naturalization was illegally procured, or was procured by concealment of a material fact or by willful misrepresentation. In such cases, the individual's certificate of naturalization is cancelled, effective as of the original date of the certificate; in other words, it is as if the individual were never a U.S. citizen at all.

### **United States immigration and visas**

In general, a non-U.S. citizen who enters the United States is required to obtain a visa.<sup>25</sup> An immigrant visa (also known as a "green card") is issued to an individual who intends to relocate to the United States permanently. Various types of nonimmigrant visas are issued to

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<sup>24</sup> 8 U.S.C. section 1481(b).

<sup>25</sup> Under the Visa Waiver Pilot Program, nationals of most European countries are not required to obtain a visa to enter the United States if they are coming as tourists and staying a maximum of 90 days. Also, citizens of Canada, Mexico, and certain islands in close proximity to the United States do not need visas to enter the United States, although other types of travel documents may be required.

individuals who come to the United States on a temporary basis and intend to return home after a certain period of time. The type of nonimmigrant visa issued to such individuals is dependent upon the purpose of the visit and its duration. An individual holding a nonimmigrant visa is prohibited from engaging in activities that are inconsistent with the purpose of the visa (for example, an individual holding a tourist visa is not permitted to obtain employment in the United States).

Foreign business people and investors often obtain "E" visas to come into the United States. Generally, an "E" visa is initially granted for a one-year period, but it can be routinely extended for additional two-year periods. There is no overall limit on the amount of time an individual may retain an "E" visa. There are two types of "E" visas: an "E-1" visa, for "treaty traders" and an "E-2" visa, for "treaty investors."

### **Relinquishment of green cards**

There are several ways in which a green card can be relinquished. First, an individual who wishes to terminate his or her permanent residency may simply return his or her green card to the INS. Second, an individual may be involuntarily deported from the United States (through a judicial or administrative proceeding), and the green card must be relinquished at that time. Third, a green card holder who leaves the United States and attempts to re-enter more than a year later may have his or her green card taken away by the INS border examiner, although the individual may appeal to an immigration judge to have the green card reinstated. A green-card holder may permanently leave the United States without relinquishing his or her green card, although such individuals would continue to be taxed as U.S. residents.<sup>26</sup>

## **Description of Proposal**

### **In general**

The proposal would replace the present-law expatriation income tax rules with rules that would generally subject certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who relinquish their U.S. residency to tax on the net unrealized gain in their property as if such property were sold for fair market value on the expatriation date. The proposal also would impose information reporting obligations on U.S. citizens who relinquish their citizenship and long-term residents whose U.S. residency is terminated.

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<sup>26</sup> Section 7701(b)(6)(B) provides that an individual who has obtained the status of residing permanently in the United States as an immigrant (i.e., an individual who has obtained a green card) will continue to be taxed as a lawful permanent resident of the United States until such status is revoked, or is administratively or judicially determined to have been abandoned.

## **Individuals covered**

The proposal would apply the expatriation tax to certain U.S. citizens and long-term residents who terminate their U.S. citizenship or residency. For this purpose, a long-term resident would be any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which the termination of residency occurs. In applying this 8-year test, an individual would not be considered to be a lawful permanent resident of the United States for any year in which the individual is taxed as a resident of another country under a treaty tie-breaker rule. An individual's U.S. residency would be considered to be terminated when either the individual ceases to be a lawful permanent resident pursuant to section 7701(b)(6) (i.e., the individual loses his or her green-card status) or the individual is treated as a resident of another country under a tie-breaker provision of a tax treaty (and the individual does not elect to waive the benefits of such treaty).

The expatriation tax under the proposal would apply only to individuals whose average income tax liability or net worth exceeds specified levels. U.S. citizens who lose their citizenship and long-term residents who terminate U.S. residency would be subject to the expatriation tax if they meet either of the following tests: (1) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of such loss or termination is greater than \$100,000, or (2) the individual's net worth as of the date of such loss or termination is \$500,000 or more. The dollar amount thresholds contained in these tests would be indexed for inflation in the case of a loss of citizenship or termination of residency occurring in any calendar year after 1996.

Exceptions from the expatriation tax under the proposal would be provided for individuals in two situations. The first exception would apply to an individual who was born with citizenship both in the United States and in another country, provided that (1) as of the date of relinquishment of U.S. citizenship the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was a resident of the United States for no more than 8 out of the 15 taxable years ending with the year in which the relinquishment of U.S. citizenship occurred. The second exception would apply to a U.S. citizen who relinquishes citizenship before reaching age 18-1/2, provided that the individual was a resident of the United States for no more than 5 taxable years before such relinquishment.

## **Deemed sale of property upon expatriation**

Under the proposal, individuals who are subject to the expatriation tax generally would be treated as having sold all of their property at fair market value immediately prior to the relinquishment of citizenship or termination of residency. Gain or loss from the deemed sale of property would be recognized at that time, generally without regard to provisions of the Code that would otherwise provide nonrecognition treatment. The net gain, if any, on the deemed sale of all such property would be subject to U.S. tax at such time to the extent it exceeds \$600,000 (\$1.2 million in the case of married individuals filing a joint return, both of whom expatriate).

The deemed sale rule of the proposal would generally apply to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency, provided that the gain on such property interest would be includible in the individual's gross income if such property interest were sold for its fair market value on such date. Special rules would apply in the case of trust interests (see "Interests in trusts", below). U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident aliens, generally would be excepted from the proposal. An exception would also apply to interests in qualified retirement plans and, subject to a limit of \$500,000, interests in certain foreign pension plans as prescribed by regulations. The Secretary of the Treasury would have authority to issue regulations exempting other property interests as appropriate.

Under the proposal, an individual subject to the expatriation tax would be required to pay a tentative tax equal to the amount of tax that would have been due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax would be based on all the income, gain, deductions, loss and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax would be due on the 90th day after the date of relinquishment of citizenship or termination of residency.

### **Deferral of payment of tax**

Under the proposal, an individual would be permitted to elect to defer payment of the expatriation tax with respect to the deemed sale of any property. Under this election, the expatriation tax with respect to a particular property, plus interest thereon, would be due when the property is subsequently disposed of. For this purpose, except as provided in regulations, the disposition of property in a nonrecognition transaction would constitute a disposition. In addition, if an individual holds property until his or her death, the individual would be treated as having disposed of the property immediately before death. In order to elect deferral of the expatriation tax, the individual would be required to provide adequate security to ensure that the deferred expatriation tax and interest would ultimately be paid. A bond in the amount of the deferred tax and interest would constitute adequate security. Other security mechanisms would also be permitted provided that the individual establishes to the satisfaction of the Secretary of the Treasury that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct such situation, the deferred expatriation tax and interest with respect to such property would become due. As a further condition to making this election, the individual would be required to consent to the waiver of any treaty rights that would preclude the collection of the expatriation tax.

### **Interests in trusts**



### **In general**

Special rules would apply to trust interests held by the individual at the time of relinquishment of citizenship or the termination of residency. The treatment of trust interests would depend upon whether the trust is a qualified trust. For this purpose, a "qualified trust" would be a trust which is organized under and governed by U.S. law and which is required by its instruments to have at least one U.S. trustee.

Constructive ownership rules would apply to a trust beneficiary that is a corporation, partnership, trust or estate. In such cases, the shareholders, partners or beneficiaries of the entity would be deemed to be the direct beneficiaries of the trust for purposes of applying these provisions. In addition, individuals who hold (or who are treated as holding) trust interests at the time of relinquishment of citizenship or termination of residency would be required to disclose on their respective tax returns the methodology used to determine that beneficiary's interest in the trust, and whether that beneficiary knows (or has reason to know) that any other beneficiary of the trust uses a different method.

### **Nonqualified trusts**

If an individual holds an interest in a trust that is not a qualified trust, a special rule would apply for purposes of determining the amount of the expatriation tax due with respect to such trust interest. The individual's interest in the trust would be treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust would be treated as having sold its assets as of the date of relinquishment of citizenship or termination of residency and having distributed all proceeds to the individual, and the individual would be treated as having recontributed such proceeds to the trust. The individual would be subject to the expatriation tax with respect to any net income or gain arising from the deemed distribution from the trust. The election to defer payment would be available for the expatriation tax attributable to a nonqualified trust interest.

A beneficiary's interest in a nonqualified trust would be determined on the basis of all facts and circumstances. These include the terms of the trust instrument itself, any letter of wishes or similar document, historical patterns of trust distributions, and the role of any trust protector or similar advisor.

### **Qualified trusts**

If the individual has an interest in a qualified trust, special rules would apply. The amount of unrealized gain allocable to the individual's trust interest would be calculated at the time of expatriation. In determining this amount, all contingencies and discretionary interests would be assumed to be resolved in the individual's favor (i.e., the individual would be allocated the maximum amount that he or she potentially could receive under the terms of the trust instrument). The expatriation tax imposed on such gains generally would be collected when the individual

receives distributions from the trust, or, if earlier, upon the individual's death. Interest would be charged for the period between the date of expatriation and the date on which the tax is paid.

If an individual has an interest in a qualified trust, the individual would be subject to expatriation tax upon the receipt of any distribution from the trust. Such distributions may also be subject to U.S. income tax. For any distribution from a qualified trust made to an individual after he or she has expatriated, expatriation tax would be imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event would the tax imposed exceed the deferred tax amount with respect to such trust interest. The "deferred tax amount" would be equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation, (2) increased by interest thereon, and (3) reduced by the tax imposed under this provision with respect to prior trust distributions to the individual.

If an individual's interest in a trust is vested as of the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest would be determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest would be determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules would apply so that the same unrealized gain with respect to assets in the trust is not taxed to both individuals.

If the individual disposes of his or her trust interest, the trust ceases to be a qualified trust, or the individual dies, expatriation tax with respect to the trust interest would be imposed on the trust as of such date (with a right of contribution for any other beneficiaries of the trust). The amount of such tax would be equal to the lesser of (1) the tax calculated under the rules for nonqualified trust interests applied as of such date or (2) the deferred tax amount with respect to the trust interest as of such date.

If the individual agrees to waive any treaty rights that would preclude collection of the tax, the tax imposed under this provision would be deducted and withheld from distributions from the qualified trust to the individual. If the individual does not agree to such a waiver of treaty rights, the tax would be imposed on the trust, the trustee would be personally liable therefor, and any other beneficiary of the trust would have a right of contribution against such individual with respect to such tax.

### **Election to be treated as a U.S. citizen**

Under the proposal, an individual would be permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that would otherwise be

covered by the expatriation tax. This election would be an "all-or-nothing" election; an individual would not be permitted to elect this treatment for some property but not other property. The election would apply to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual would continue to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property, as well as any excise tax imposed with respect to the property (see, e.g., sec. 1491). In addition, the property would continue to be subject to U.S. gift, estate, and generation-skipping transfer taxes. However, the amount of any transfer tax so imposed would be limited to the amount of income tax that would have been due if the property had been sold for its fair market value immediately before the transfer or death. The \$600,000 exclusion provided under the expatriation tax would be available to reduce the tax imposed by reason of this election. In order to make this election, the taxpayer would be required to waive any treaty rights that would preclude the collection of the tax. The individual would also be required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary requires.

#### **Date of relinquishment of citizenship**

Under the proposal, an individual would be treated as having relinquished U.S. citizenship on the date that the individual first makes known to a U.S. government or consular officer his or her intention to relinquish U.S. citizenship. Thus, a U.S. citizen who relinquishes citizenship by formally renouncing his or her U.S. nationality before a diplomatic or consular officer of the United States would be treated as having relinquished citizenship on that date, provided that the renunciation is later confirmed by the issuance of a CLN. A U.S. citizen who furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act would be treated as having relinquished his or her citizenship on the date the statement is so furnished (regardless of when the expatriating act was performed), provided that the voluntary relinquishment is later confirmed by the issuance of a CLN. If neither of these circumstances exist, the individual would be treated as having relinquished citizenship on the date a CLN is issued or a certificate of naturalization is cancelled. The date of relinquishment of citizenship determined under the proposal would apply for all tax purposes.

#### **Effect on present-law expatriation provisions**

Under the proposal, the present-law provisions with respect to U.S. citizens who expatriate with a principal purpose of avoiding tax (sec. 877) and certain aliens who have a break in residency status (sec. 7701(b)(10)) would not apply to U.S. citizens who are treated as relinquishing their citizenship on or after February 6, 1995 or to long-term U.S. residents who terminate their residency on or after such date. The special estate and gift tax provisions with respect to individuals who expatriate with a principal purpose of avoiding tax (secs. 2107 and 2501(a)(3)), however, would continue to apply; a credit against the tax imposed solely by reason

of such special provisions would be allowed for the expatriation tax imposed with respect to the same property.

### **Treatment of gifts and inheritances from an expatriate**

Under the proposal, the exclusion from income provided in section 102 would not apply to the value of any property received by gift or inheritance from an individual who was subject to the expatriation tax (i.e., an individual who relinquished citizenship or terminated residency and to whom the expatriation tax was applicable). Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual would be required to include the value of such gift or inheritance in gross income and would be subject to U.S. income tax on such amount.

### **Required information reporting and sharing**

Under the proposal, an individual who relinquishes citizenship or terminates residency would be required to provide a statement which includes the individual's social security number, forwarding foreign address, new country of residence and citizenship and, in the case of individuals with a net worth of at least \$500,000, a balance sheet. The entity to which such statement is to be provided would be required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. An individual's failure to provide the required statement would result in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year or (2) \$1,000.

The proposal would require the State Department to provide the Secretary of the Treasury with a copy of each CLN approved by the State Department. Similarly, the proposal would require the agency administering the immigration laws to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned.

Further, the proposal would require the Secretary of the Treasury to publish in the Federal Register the names of all former U.S. citizens from whom it receives the required statements or whose names it receives under the foregoing information-sharing provisions.

### **Effective Date**

The proposal would be effective for U.S. citizens whose date of relinquishment of citizenship (as determined under the proposal, see "Date of relinquishment of citizenship" above) occurs on or after February 6, 1995. Similarly, the proposal would be effective for long-term residents who terminate their U.S. residency on or after February 6, 1995.

U.S. citizens who committed an expatriating act prior to February 6, 1995, but whose date of relinquishment of citizenship does not occur until after such date, would be subject to the

expatriation tax under the proposal as of date of relinquishment of citizenship. However, the individual would not be subject retroactively to worldwide tax as a U.S. citizen for the period after he or she committed the expatriating act (and therefore ceased being a U.S. citizen for tax purposes under present law). Such an individual would continue to be subject to the expatriation tax imposed by present-law section 877 until the individual's date of relinquishment of citizenship (at which time the individual would be subject to the expatriation tax of the proposal).

The tentative tax would not be required to be paid, and the reporting requirements would not be required to be met, until 90 days after the date of enactment. Such provisions would apply to all individuals whose date of relinquishment of U.S. citizenship or termination of U.S. residency occurs on or after February 6, 1995.

## VI. TAXPAYER BILL OF RIGHTS 2 PROVISIONS

### 1. Abatement of interest and penalties

#### a. Expansion of authority to abate interest

##### Present Law

Any assessment of interest on any deficiency attributable in whole or in part to any error or delay by an officer or employee of the IRS (acting in his official capacity) in performing a ministerial act may be abated.

##### Description of Proposal

The proposal would permit the IRS to abate interest with respect to any unreasonable error or delay resulting from managerial acts as well as ministerial acts. This would include extensive delays resulting from managerial acts such as: the loss of records by the IRS, IRS personnel transfers, extended illnesses, extended personnel training, or extended leave. On the other hand, interest would not be abated for delays resulting from general administrative decisions. For example, the taxpayer could not claim that the IRS's decision on how to organize the processing of tax returns or its delay in implementing an improved computer system resulted in an unreasonable delay in the IRS's action on the taxpayer's tax return, and so the interest on any subsequent deficiency should be waived.

##### Effective Date

The proposal would apply to interest accruing with respect to deficiencies or payments for taxable years beginning after the date of enactment.

#### b. Review of IRS failure to abate interest

##### Present Law

Federal courts generally do not have the jurisdiction to review the IRS's failure to abate interest.

##### Description of Proposal

The proposal would grant the Tax Court jurisdiction to determine whether the IRS's failure to abate interest for an eligible taxpayer was an abuse of discretion. The action must be brought within six months after the date of the Secretary's final determination not to abate interest. An eligible taxpayer must meet the net worth and size requirements imposed with

respect to awards of attorney's fees. No inference is intended as to whether under present law any court has jurisdiction to review IRS's failure to abate interest.

#### **Effective Date**

The proposal would apply to requests for abatement after the date of enactment.

### **2. Joint return may be made after separate returns without full payment of tax**

#### **Present Law**

Taxpayers who file separate returns and subsequently determine that their tax liability would have been less if they had filed a joint return are precluded by statute from reducing their tax liability by filing jointly if they are unable to pay the entire amount of the joint return liability before the expiration of the three-year period for making the election to file jointly.

#### **Description of Proposal**

The proposal would repeal the requirement of full payment of tax liability as a precondition to switching from married filing separately status to married filing jointly status.

#### **Effective Date**

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

### **3. Collection activities**

#### **a. Modifications in certain levy exemption amounts**

#### **Present Law**

Property exempt from levy includes personal property with a value of up to \$1,650 as well as books and tools with a value of up to \$1,100.

#### **Description of Proposal**

The proposal would increase the exemption amount to \$2,500 for personal property and to \$1,250 for books and tools. These amounts would be indexed for inflation commencing January 1, 1996.

#### **Effective Date**

The proposal would be effective with respect to levies issued after December 31, 1995.

## **b. Offers-in-compromise**

### **Present Law**

The IRS has the authority to settle a tax debt pursuant to an offer-in-compromise. IRS regulations provide that such offers can be accepted if: the taxpayer is unable to pay the full amount of the tax liability and it is doubtful that the tax, interest, and penalties can be collected or there is doubt as to the validity of the actual tax liability. Amounts over \$500 can only be accepted if the reasons for the acceptance are documented in detail and supported by an opinion of the IRS Chief Counsel.

### **Description of Proposal**

The proposal would increase from \$500 to \$50,000 the amount requiring a written opinion from the Office of Chief Counsel. Compromises below the \$50,000 threshold would be subject to continuing quality review by the IRS.

### **Effective Date**

The proposal would be effective on the date of enactment.

## **4. Award of litigation costs permitted in declaratory judgment proceedings**

### **Present Law**

Section 7430(b)(3) denies any reimbursement for attorney's fees in all declaratory judgment actions, except those actions related to the revocation of an organization's qualification under section 501(c)(3) (relating to tax-exempt status).

### **Description of Proposal**

The proposal would eliminate the present-law restrictions on awarding attorney's fees in all declaratory judgment proceedings.

### **Effective Date**

The proposal would apply to proceedings commenced after the date of enactment.



## **5. Modifications of rules relating to summonses**

### **a. Enrolled agents included as third-party recordkeepers**

#### **Present Law**

Section 7609 contains special procedures that the IRS must follow before it issues a third-party summons. A third-party summons is a summons issued to a third-party recordkeeper compelling him to provide information with respect to the taxpayer. An example of this would be a summons served on a stock brokerage house to provide data on the securities trading of the taxpayer-client.

If a third-party summons is served on a third-party recordkeeper listed in section 7609(a)(3), then the taxpayer must receive notice of the summons and have an opportunity to challenge the summons in court. Otherwise the taxpayer has no statutory right to receive notice of the summons and accordingly he will not have the opportunity to challenge it in court.

Section 7609(a)(3) lists attorneys and accountants as third-party recordkeepers, but it does not list "enrolled agents", who are authorized to practice before the IRS.

#### **Description of Proposal**

The proposal would include enrolled agents as third-party recordkeepers.

#### **Effective Date**

The proposal would apply to summonses issued after the date of enactment.

### **b. Safeguards relating to designated summonses**

#### **Present Law**

The period for assessment of additional tax with respect to most tax returns, corporate or otherwise, is three years. The IRS and the taxpayer can together agree to extend the period, either for a specified period of time or indefinitely. The taxpayer may terminate an indefinite agreement to extend the period by providing notice to the IRS.

During an audit, the IRS may informally request that the taxpayer provide additional information necessary to arrive at a fair and accurate audit adjustment, if any adjustment is warranted. Not all taxpayers cooperate by providing the requested information on a timely basis. In some cases the IRS seeks information by issuing an administrative summons. Such a summons will not be judicially enforced unless the Government (as a practical matter, the Department of

Justice) seeks and obtains an order for enforcement in Federal court. In addition, a taxpayer may petition the court to quash an administrative summons where this is permitted by statute.<sup>1</sup>

In certain cases, the running of the assessment period is suspended during the period when the parties are in court to obtain or avoid judicial enforcement of an administrative summons. Such a suspension is provided in the case of litigation over a third-party summons (sec. 7609(e)) or litigation over a summons regarding the examination of a related party transaction. Such a suspension can also occur with respect to a corporate tax return if a summons is issued at least 60 days before the day on which the assessment period (as extended) is scheduled to expire. In this case, suspension is only permitted if the summons clearly states that it is a "designated summons" for this purpose. Only one summons may be treated as a designated summons for purposes of any one tax return. The limitations period is suspended during the judicial enforcement period of the designated summons and of any other summons relating to the same tax return that is issued within 30 days after the designated summons is issued.

### **Description of Proposal**

The proposal would limit the use of a designated summons to corporations (or to any other person to whom the corporation has transferred records) that are being examined as part of the Coordinated Examination Program (CEP) or its successor. CEP audits cover about 1,600 of the largest corporate taxpayers. If a corporation moves between CEP and non-CEP audit categories, only the tax years covered by the CEP may be the subject of a designated summons. The proposal would not affect Code section 6038A(e)(1), which relates to a U.S. reporting corporation that acts merely as the agent of the foreign related party by receiving summonses on behalf of the foreign party.

### **Effective Date**

The proposal would apply to summonses issued after date of enactment.

## **6. Annual reminders to taxpayers with outstanding delinquent accounts**

### **Present Law**

There is no statutory requirement in the Code that the IRS send annual reminders to persons who have outstanding tax liabilities.

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<sup>1</sup> Petitions to quash are permitted, for example, in connection with the examination of certain related party transactions under section 6038A(e)(4), and in the case of certain third-party summonses under section 7609(b)(2).

Numerous taxpayers become delinquent in paying their tax liability. The delinquencies may occur because the person did not make enough payments through payroll withholding or quarterly estimated payments or because of an adjustment following an audit.

The IRS generally pursues larger tax deficiencies first, and then it pursues small deficiencies. Because of the limited amount of IRS resources to work collection cases, cases with smaller deficiencies may not be addressed for years. In the meantime, the taxpayer may come to believe that the apparent lack of IRS collection activity means that it has abandoned its claim against the taxpayer. The taxpayer may be surprised when the IRS resumes collection action years later, when the 10-year statute of limitations on collections is close to expiring.

#### **Description of Proposal**

The proposal would require the IRS to send taxpayers an annual reminder of their outstanding tax liabilities. The fact that a taxpayer did not receive a timely, annual reminder notice would not affect the tax liability.

#### **Effective Date**

The proposal would require the IRS to send annual reminder notices beginning in 1996.

### **7. Court discretion to reduce award for litigation costs for failure to exhaust administrative remedies**

#### **Present Law**

A taxpayer suing the United States for civil damages for unauthorized collection activities must exhaust administrative remedies to be eligible for an award.

#### **Description of Proposal**

The proposal would permit (but not require) a court to reduce an award if the taxpayer has not exhausted administrative remedies.

#### **Effective Date**

The proposal would be effective for proceedings commenced after the date of enactment.

## VII. CASUALTY AND INVOLUNTARY CONVERSION PROVISIONS

### A. Modify Basis Adjustment Rules Under Section 1033

#### Present Law

Gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases similar property within a specified period of time. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns similar replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property. In cases in which a taxpayer purchases stock as replacement property, the taxpayer reduces the basis of the stock, but does not reduce the basis of the underlying assets. Thus, the reduction in the basis of the stock generally does not result in reduced depreciation deductions where the corporation holds depreciable property, and may result in the taxpayer having more aggregate depreciable basis after the acquisition of replacement property than before the involuntary conversion.

#### Description of Proposal

The proposal would provide that where the taxpayer satisfies the replacement property requirement by acquiring stock in a corporation, the corporation generally would reduce its adjusted bases in its assets by the amount by which the taxpayer reduces its basis in the stock. The corporation's adjusted bases in its assets would not be reduced, in the aggregate, below the taxpayer's basis in its stock (determined after the appropriate basis adjustment for the stock). In addition, the basis of any individual asset would not be reduced below zero.

The application of these rules can be demonstrated by the following examples:

Example 1.--Assume that a taxpayer owned a commercial building with an adjusted basis of \$100,000 that was involuntarily converted, causing the taxpayer to receive \$1 million in insurance proceeds. Further assume that the taxpayer acquires, as replacement property, all of the stock of a corporation, the sole asset of the corporation is a building with a value and an adjusted basis of \$1 million. Under the proposal, the taxpayer would reduce its basis in the stock to \$100,000 (as under present law) and the corporation would reduce its adjusted basis in the building to \$100,000.

Example 2.--Assume the same facts as in Example 1, except that on the date of acquisition, the corporation has an adjusted basis of \$100,000 (rather than \$1 million) in the building. Under the proposal, the taxpayer would reduce its basis in the stock to \$100,000 (as under present law) and the corporation would not be required to reduce its adjusted basis in the building.

**Effective Date**

The proposal would apply to involuntary conversions occurring after September 13, 1995.

**B. Modify the Exception to the Related Party Rule of Section 1033 for Individuals to Only Provide an Exception for De Minimis Amounts**

**Present Law**

Gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified period of time. Pursuant to a provision of H.R. 831, as passed by the Congress and signed by the President on April 11, 1995 (P.L.104-7), subchapter C corporations (and certain partnerships with corporate partners) are not entitled to defer gain if the replacement property or stock is purchased from a related person. An exception to this related party rule provides that a taxpayer may purchase replacement property or stock from a related person and defer gain to the extent the related person acquired the replacement property or stock from an unrelated person within the period prescribed under section 1033.

**Description of Proposal**

The proposal would expand the present-law denial of the application of section 1033 to any other taxpayer (including an individual) that acquires replacement property from a related party, unless the taxpayer has aggregate realized gain of \$100,000 or less for the taxable year with respect to converted property with aggregate realized gains.

**Effective Date**

The proposal would apply to involuntary conversions occurring after September 13, 1995.

## **C. Treatment of Certain Crop Insurance Proceeds and Disaster Assistance Payments**

### **Present Law**

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

### **Description of Proposal**

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

Thus, for example, the proposal would allow a calendar-year, cash method taxpayer who has received disaster assistance payments in 1997 relating to the destruction of crops by a flood in 1996 to elect to treat such payments as received in 1996, so long as the taxpayer establishes that, under the taxpayer's practice, income from such crops would have been reported in 1996. Without the benefit of the proposal, the income of such a taxpayer would be "bunched" in 1997, possibly resulting in the loss of itemized deductions in 1996, a higher marginal income tax rate in 1997, and the loss of AGI-based deductions and exemptions in 1997.

### **Effective Date**

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

## **D. Application of Involuntary Conversion Rules to Property Damaged as a Result of Presidentially Declared Disasters**

### **Present Law**

Under present law, a taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires similar property within an applicable period. The applicable period generally begins with the date of the disposition of the converted property and generally ends two years after the close of the first taxable year in which any part of the gain upon conversion is realized. If the taxpayer does not replace the converted property with similar property, then gain generally is recognized.

### **Description of Proposal**

For purposes of the involuntary conversion rules, any tangible property acquired and held for productive use in a business would be treated as similar to Presidential disaster area property. "Presidential disaster area property" would be property that (1) was held for investment or for productive use in a business, (2) was involuntarily converted as a result of a disaster, and (3) was located in a Presidential declared disaster area.

### **Effective Date**

The proposal would be effective for disasters declared after December 31, 1994.



## VIII. EXEMPT ORGANIZATIONS AND CHARITABLE REFORMS

### A. Common Investment Fund for Private Foundations

#### Present Law

Code section 501(c)(3) requires that an organization be organized and operated exclusively for a charitable or other exempt purpose in order to qualify for tax-exempt status under that section.

Section 501(f) provides that an organization is treated as organized and operated exclusively for charitable purposes if it is comprised solely of members that are educational institutions and is organized and operated solely to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) funds contributed by the members in stocks and securities, and to collect income from such investments and turn over such income, less expenses, to the members.

#### Description of Proposal

A cooperative service organization comprised solely of members that are tax-exempt private foundations and community foundations would be treated as organized and operated exclusively for charitable purposes if: (1) it has at least 20 members; (2) no one member holds (after the organization's second taxable year) more than 10 percent (by value) of the interests in the organization; (3) it is organized and controlled by its members, but no one member by itself controls the organization or any other member; (4) the members are permitted to dismiss any of the organization's investment advisors, if (following reasonable notice) members holding a majority of interest in the account managed by such advisor vote to remove such advisor; and (5) the organization is organized and operated solely to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) funds contributed by the members in stocks and securities, and to collect income from such investments and turn over such income, less expenses, to the members.<sup>1</sup>

A cooperative service organization meeting the criteria of the proposal would be subject to the present-law excise tax provisions applicable to private foundations (e.g., sec. 4941 rules governing self-dealing arrangements), other than sections 4940 and 4942.<sup>2</sup> In addition, each

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<sup>1</sup> Legislative history would indicate that an organization would be deemed to be organized and operated solely to collectively invest in stocks and securities if its investment portfolio consists solely of stocks and securities, and ordinary and routine investments held in connection with a stock and securities portfolio.

<sup>2</sup> In addition, the proposal would provide that the present-law expenditure responsibility requirements of section 4945(d)(4)(B) would not apply to grants made by private foundations to

member's allocable share (whether or not distributed) of the capital gain net income and gross investment income of the organization for any taxable year of the organization would be treated, for purposes of the excise tax imposed under present-law section 4940, as capital gain net income and gross investment income of the member for the taxable year of such member in which the taxable year of the organization ends.

#### **Effective Date**

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

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the cooperative service organization and that such grants would be deemed to be qualifying distributions for purposes of 4942.

## **B. Exclusion From UBIT for Corporate Sponsorship Payments Received by Tax-Exempt Organizations in Connection With Public Events**

### **Present Law**

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511-514). Contributions or gifts received by tax-exempt organizations generally are not subject to the UBIT. However, present-law section 513(c) provides that an activity (such as advertising) does not lose its identity as a separate trade or business merely because it is carried on within a larger complex of other endeavors.<sup>3</sup> If a tax-exempt organization receives sponsorship payments in connection with conducting a public event, the solicitation and receipt of such sponsorship payments may be treated as a separate activity. The Internal Revenue Service (IRS) has taken the position that, under some circumstances, such sponsorship payments may be subject to the UBIT.<sup>4</sup>

### **Description of Proposal**

Under the proposal, qualified sponsorship payments received by certain tax-exempt organizations in connection with qualified public events would be excluded from the UBIT.

The term "qualified public event" would be defined as any event conducted by a tax-exempt organization described in paragraph (3), (4), (5), or (6) of section 501(c),<sup>5</sup> that is either:

- (1) a public event that is substantially related to the exempt purposes of the organization conducting such event, or

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<sup>3</sup> See United States v. American College of Physicians, 475 U.S. 834 (1986) (holding that activity of selling advertising in medical journal was not substantially related to the organization's exempt purposes and, as a separate business under section 513(c), was subject to tax).

<sup>4</sup> See Prop. Treas. Reg. sec. 1.513-4 (issued January 19, 1993, EE-74-92, IRB 1993-7, 71). These proposed regulations generally exclude from the UBIT financial arrangements under which the tax-exempt organization provides so-called "institutional" or "good will" advertising to a sponsor (i.e., arrangements under which a sponsor's name, logo, or product line is acknowledged by the tax-exempt organization). However, specific product advertising (e.g., "comparative or qualitative descriptions of the sponsor's products") provided by a tax-exempt organization on behalf of a sponsor is not shielded from the UBIT under the proposed regulations.

<sup>5</sup> In addition, events conducted by State colleges and universities described in section 511(d)(2)(B) would be eligible for the UBIT exception provided for by the proposal.

(2) any other public event provided that such event is the only event of that type conducted (i.e., patronized by, or broadcast to, members of the public) by such organization during a calendar year and such event does not exceed 30 consecutive days.<sup>6</sup>

Public events that are substantially related to the exempt purposes of the organization conducting the event (e.g., symphony concerts, museum exhibits, intercollegiate athletic events, and county and agricultural fairs) would be governed by the proposal, even if held for more than a 30-day period. A public event conducted once a year for a period that does not exceed 30 days also would be governed by the proposal, even if the event is not substantially related to the exempt purposes of the organization (e.g., an annual vaudeville show conducted by a hospital or an annual auction or other fundraising event).

For purposes of the proposal, "qualified sponsorship payments" received by a tax-exempt organization that are excluded from UBIT would be defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than:

- (1) the use of the name or logo of the person's trade or business in connection with a qualified public event under arrangements (including advertising) in connection with such event which acknowledge such person's sponsorship or promote such person's products or services, or
- (2) the furnishing of facilities, services, or other privileges in connection with such event to individuals designated by such person (e.g., tickets furnished to employees).<sup>7</sup>

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<sup>6</sup> The proposal would provide that an event is treated as a qualified public event with respect to all qualified tax-exempt organizations that receive sponsorship payments with respect to the event if such event is a qualified public event with respect to one of such organizations, but only to the extent that such payment is used to meet expenses of such event or for the benefit of the organization with respect to which the event is a qualified public event. Thus, if a national charitable organization receives sponsorship payments with respect to several local fundraising events conducted in conjunction with local affiliates (e.g., walk-a-thons at different sites around the country), the national organization would not be subject to the UBIT with respect to sponsorship payments used to meet event expenses or distributed to local affiliates (assuming the events are qualified public events with respect to the local affiliates).

<sup>7</sup> The "in connection with" requirement would be satisfied only if benefits provided to the sponsor (or individuals designated by the sponsor) are provided within a reasonable time period compared to when the qualified public event itself is patronized by (or broadcast to) the public and only if the benefits are provided in a manner reasonably related to the conduct of the public event activities (e.g., providing advertising in a program or brochure distributed to event patrons, or providing special seating at the event, or related pre- or post-event functions, to employees of the sponsor).

To prevent avoidance of the 30-day rule governing unrelated events, the Secretary of the Treasury would be granted authority to prescribe regulations to prevent avoidance of the purposes of the provision through the use of entities under common control.<sup>8</sup>

The exception provided for by the proposal would be in addition to other present-law exceptions from the UBIT (e.g., the exceptions for activities substantially all the work for which is performed by volunteers and for activities not regularly carried on). No inference would be intended as to the tax treatment under present-law rules of sponsorship payments received in connection with events not governed by the provision (e.g., unrelated events held more than once per year or for more than 30 days) or events held by organizations that are not covered by the provision (e.g., 501(c)(10) fraternal organizations).

#### **Effective Date**

The proposal would apply to events conducted after 1995.

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<sup>8</sup> For this purpose, it is intended that organizations that conduct public events would not be treated as under common control solely as a result of their common affiliation with a national sanctioning body.

## **C. Treatment of Dues Paid to Agricultural or Horticultural Organizations**

### **Present Law**

Tax-exempt organizations generally are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511-514). Dues payments made to a membership organization generally are not subject to the UBIT. However, several courts have held that, with respect to postal labor organizations, dues payments were subject to the UBIT when received from individuals who were not postal workers but who became "associate" members for the purpose of obtaining health insurance available to members of the organization. See National League of Postmasters of the United States v. Commissioner, No. 8032-93, T.C. Memo (May 11, 1995); American Postal Workers Union, AFL-CIO v. United States, 925 F.2d 480 (D.C. Cir. 1991); National Association of Postal Supervisors v. United States, 944 F.2d 859 (Fed. Cir. 1991).

In Rev. Proc. 95-21 (issued March 23, 1995), the IRS set forth its position regarding when associate member dues payments received by an organization described in section 501(c)(5) will be treated as subject to the UBIT. The IRS stated that dues payments from associate members will not be treated as subject to UBIT unless, for the relevant period, "the associate member category has been formed or availed of for the principal purpose of producing unrelated business income." Thus, under Rev. Proc. 95-21, the focus of the inquiry is upon the organization's purposes in forming the associate member category (and whether the purposes of that category of membership are substantially related to the organization's exempt purposes other than through the production of income), rather than upon the motive of the individuals who join as associate members.

### **Description of Proposal**

Under the proposal, if an agricultural or horticultural organization described in section 501(c)(5) requires annual dues not exceeding \$100 to be paid in order to be a member of such organization, then in no event would any portion of such dues be subject to the UBIT by reason of any benefits or privileges to which members of such organization are entitled. For taxable years beginning after 1995, the \$100 amount would be indexed for inflation. The term "dues" would be defined as "any payment required to be made in order to be recognized by the organization as a member of the organization."<sup>9</sup>

### **Effective Date**

The proposal would apply to taxable years beginning after December 31, 1994.

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<sup>9</sup> Legislative history would indicate that no inference would be intended regarding the UBIT treatment of any dues payment not governed by the proposal.

## **D. Repeal Tax Credit for Contributions to Special Community Development Corporations**

### **Present Law**

Taxpayers are entitled to claim a tax credit for qualified contributions made to one of 20 non-profit community development corporations (CDCs) selected by the Secretary of HUD to provide assistance in economically distressed areas. A qualified contribution means a transfer of cash to a selected CDC (made in the form of an equity investment or loan) which is made available for use by the CDC for at least 10 years to provide employment and business opportunities to low-income residents who live in an area where (1) the unemployment rate is not less than the national unemployment rate and (2) the median family income does not exceed 80 percent of the median gross income of residents of the jurisdiction of the local government which includes such area.<sup>10</sup>

If a taxpayer makes a qualified contribution, the credit may be claimed by the taxpayer for each taxable year during the 10-year period beginning with the taxable year during which the contribution was made. The credit that may be claimed for each year is equal to 5 percent of the amount of the contribution to the CDC. Thus, during the 10-year credit period, the taxpayer may claim aggregate credit amounts totalling 50 percent of his or her contribution. The aggregate amount of contributions that may be designated by any one CDC as eligible for the credit may not exceed \$2 million. (Consequently, a total amount of \$40 million in contributions will be eligible for the credit with respect to all 20 selected CDCs--and the maximum credit amounts will total \$20 million over the 10-year credit period.)

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

### **Description of Proposal**

The special tax credit for qualified contributions to selected community development corporations would be repealed.

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<sup>10</sup> The contribution to the CDC must be available for use by the CDC for at least ten years, but need not meet the requirements of a "contribution or gift" for purposes of section 170. In other words, a contribution eligible for the credit may be made in the form of a 10-year loan (or other long-term investment), the principal of which is to be returned to the taxpayer after the 10-year period. However, in the case of a donation of cash made by a taxpayer to an eligible CDC, the taxpayer is allowed to claim a charitable contribution deduction (subject to present-law rules under section 170), in addition to the special credit for qualified contributions to a selected CDC.

### **Effective Date**

The proposal would be effective for contributions made after the date of enactment (other than a contribution made pursuant to a legally enforceable agreement to make such contribution, if such agreement is in effect on the date of enactment).



## **E. Required Notices to Charitable Beneficiaries of Charitable Remainder Trusts**

### **Present Law**

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

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

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

### **Description of Proposal**

The proposal would require an executor claiming a charitable deduction on the estate tax return for certain qualified remainder interests to provide to the beneficiary of such a remainder interest notification that such a remainder interest has been created. Such notice would be provided to the beneficiary within three months of the due date (or any extension thereof) for filing the estate tax return. This notification requirement would not apply in the case of a contingent remainder interest.

The proposal would further require the fiduciary of certain trusts with a charitable remainder interest to notify annually the beneficiary of such a remainder interest that such a remainder interest exists. The proposal would provide exceptions to this annual notification requirement if the Secretary determines it is not necessary for the efficient administration of tax law; if the fiduciary has previously provided notification; if the beneficiary relieves the fiduciary of the requirement; or if, as provided under State law, the fiduciary provides periodic accounting to the beneficiary of the remainder interest. The annual notification requirement would not apply in the case of a contingent remainder interest.

### **Effective Date**

The proposal with respect to notification relating to charitable interest claimed on estate tax returns would be effective after December 31, 1995. The annual notification requirement would be effective for taxable years beginning after December 31, 1995.

## **F. Treat Qualified Football Coaches Plan as Multiemployer Pension Plan for Purposes of the Internal Revenue Code**

### **Present Law**

Under present law, a tax-qualified pension plan (including a qualified cash or deferred arrangement) must be maintained for the exclusive benefit of the employees and their beneficiaries covered under the plan.

The American Football Coaches Association ("AFCA") is a tax-exempt organization described in section 501(c)(6) of the Code. The members of the AFCA include college coaches, athletic directors, and high school coaches; the participating members of the AFCA are not employees of the organization. The AFCA maintains a cash or deferred arrangement (i.e., a "401(k) plan") on behalf of participating members.

The Employee Retirement Income Security Act of 1974 ("ERISA"), as amended by the Continuing Appropriations for Fiscal Year 1988, provides that, for purposes of the labor law provisions of ERISA, a qualified football coaches plan generally is treated as a multiemployer plan and may include a qualified cash or deferred arrangement. Under ERISA, a qualified football coaches plan is defined as any defined contribution plan established and maintained by an organization described in Code section 501(c)(6), the membership of which consists entirely of individuals who primarily coach football as full-time employees of 4-year colleges or universities, if the organization was in existence on September 18, 1986. This definition is generally intended to apply to the AFCA.

However, the Omnibus Budget Reconciliation Act of 1987 provided that certain provisions of ERISA are not applicable in interpreting the Internal Revenue Code, except to the extent specifically provided in the Code or as determined by the Secretary of the Treasury.

The Internal Revenue Service determined that the cash or deferred arrangement maintained by the AFCA is not a qualified cash or deferred arrangement under the Internal Revenue Code. In making this determination, the IRS also observed that the AFCA plan may also violate a number of provisions of the Code. For example, the Code requires that a qualified plan be maintained for the benefit of employees, but the coaches are not employees of the AFCA.

### **Description of Proposal**

A technical correction to the Continuing Appropriations for Fiscal Year 1988 would provide that a qualified football coaches plan (as defined in ERISA) is eligible to maintain a qualified cash or deferred arrangement under the Internal Revenue Code on behalf of the football coaches belonging to the AFCA. In order for the plan to be reinstated as a qualified football coaches plan, a \$25,000 excise tax would be imposed on the plan.

### **Effective Date**

The proposal would generally be effective as if included in the Continuing Appropriations for Fiscal Year 1988 (i.e., years beginning after December 22, 1987). The excise tax would have to be paid in the first plan year beginning after the date of enactment.

## **IX. CORPORATE AND OTHER TAX REFORMS AND MISCELLANEOUS PROVISIONS**

### **1. Reform the tax treatment of certain corporate stock redemptions**

#### **Present Law**

A corporate shareholder generally can deduct at least 70 percent of a dividend received from another corporation. This dividends received deduction is 80 percent if the corporate shareholder owns at least 20 percent of the distributing corporation and generally 100 percent if the shareholder owns at least 80 percent of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was paid by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non pro rata redemption or a partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is paid, the excess is taxed as gain on the sale or disposition of such stock, but not until that time (sec. 1059(a)(2)).

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend (sec. 302). A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. Section 302(b) also contains several specific tests (e.g., a substantial reduction computation and a termination test) to identify redemptions that are not essentially equivalent to dividends. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4).

#### **Description of Proposal**

Under the proposal, except as provided in regulations, a corporate shareholder would recognize gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership.<sup>1</sup>

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<sup>1</sup> Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient earnings and profits, the rule would apply to the portion treated as a dividend.

In addition, the proposal would require immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero.

Reorganizations or other exchanges involving amounts that are treated as dividends under section 356(a)(2) of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e). For example, if a recapitalization or other transaction that involves a dividend under section 356 has the effect of a non-pro rata redemption or is treated as a dividend due to options being counted as stock, the rules of section 1059 apply. Redemptions of shares (or other extraordinary dividends on shares) held by a partnership will be subject to section 1059 to the extent there are corporate partners (e.g., appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest will be required).

Finally, under continuing section 1059(g) of present law, the Treasury Department would be authorized to issue regulations where necessary to carry out the purposes and prevent the avoidance of the provision.

### **Effective Date**

The proposal would generally be effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on that date. However, in applying the new gain recognition rules to any distribution that is not a partial liquidation, a non-pro rata redemption, or a redemption that is treated as a dividend by reason of options, September 13, 1995 would be substituted for May 3, 1995 in applying the transition rules.

No inference is intended regarding the tax treatment under present law of any transaction within the scope of the proposal, including transactions utilizing options.

## **2. Require corporate tax shelter reporting**

### **Present Law**

An organizer of a tax shelter is required to register the shelter with the Internal Revenue Service (IRS) (sec. 6111). If the principal organizer does not do so, the duty may fall upon any other participant in the organization of the shelter or any person participating in its sale or management. The shelter's identification number must be furnished to each investor who purchases or acquires an interest in the shelter. Failure to furnish this number to the tax shelter investors will subject the organizer to a \$100 penalty for each such failure (sec. 6707(b)).

A penalty may be imposed against an organizer who fails without reasonable cause to timely register the shelter or who provides false or incomplete information with respect to it. The penalty is the greater of one percent of the aggregate amount invested in the shelter or \$500. Any person claiming any tax benefit with respect to a shelter must report its registration number on her

return. Failure to do so without reasonable cause will subject that person to a \$250 penalty (sec. 6707(b)(2)).

A person who organizes or sells an interest in a tax shelter subject to the registration rule or in any other potentially abusive plan or arrangement must maintain a list of the investors (Code sec. 6112). A \$50 penalty may be assessed for each name omitted from the list. The maximum penalty per year is \$100,000 (sec. 6708).

For this purpose, a tax shelter is defined as any investment that meets two requirements. First, the investment must be (1) required to be registered under a Federal or state law regulating securities, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or state agency regulating the offering or sale of securities, or (3) a substantial investment. Second, it must be reasonable to infer that the ratio of deductions and 350% of credits to investment for any investor (i.e., the tax shelter ratio) may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale. An investment that meets these requirements will be considered a tax shelter regardless of whether it is marketed or customarily designated as a tax shelter (sec. 6111(c)(1)).

### **Description of Proposal**

The proposal would require a promoter of a corporate tax shelter to register the shelter with the Secretary. Registration would be required not later than the next business day after the day when the tax shelter is first offered to potential users. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant is required to register the shelter. An exception to this special rule provides that registration is not required if the U.S. participant notifies the promoter in writing not later than the seventh day after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

A corporate tax shelter is any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of \$100,000. A transaction is offered under conditions of confidentiality if: (a) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (b) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter would include related parties.

Registration will require the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters would be required to maintain lists of those who have signed confidentiality agreements, or otherwise been subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters would have to retain lists of those paying fees with respect to plans or arrangements which have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations will be treated as taxpayer information under the provisions of section 6103 and will therefore not be subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter would be the greater of \$10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty would not apply to fee payments with respect to offerings after late registration). A similar penalty would apply to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50-percent penalty would only be based on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant would result in the 50-percent penalty being increased to 75 percent of the applicable fees.

### **Effective Date**

The proposal would apply to any tax shelter offered to potential participants after the date of enactment. No filings would be due, however, until the Treasury Department issues guidance with respect to the filing requirements.

### **3. Disallow interest deduction for corporate-owned life insurance policy loans**

#### **Present Law**

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").<sup>2</sup> Further, an exclusion from Federal income tax

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<sup>2</sup> This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income. In the case of a modified endowment contract, however, distributions are treated as income first, loans are treated as distributions (i.e., income rather than



is provided for amounts received under a life insurance contract paid by reason of the death of the insured. The policyholder may borrow with respect to the life insurance contract without affecting these exclusions, subject to certain limitations.

Considerable publicity has been focused on the magnitude of business borrowings with respect to life insurance and the scale of the tax benefits. In a recent article describing corporate-owned life insurance ("COLI"), it was stated, "COLIs can net big bucks. After 40 years, a COLI program that pays a \$10,000 annual premium on each of 5,000 employees will produce about \$450 million in death benefits and \$300 million in tax benefits -- netting the company \$230 million."<sup>3</sup>

A company that sets up a COLI program typically purchases life insurance on the lives of its employees, in many cases thousands or tens of thousands of employees.<sup>4</sup> The company, not the employee or his family, receives all or most of the proceeds on the employee's death. The company borrows against the value of the life insurance policies at an interest rate just above the rate at which inside buildup is credited under the policy. The interest that the company pays on policy loans from the insurer is credited under the policy and increases the tax-free inside buildup. At the same time, the company deducts the interest it pays. The company shows a positive return on the COLI program, because the after-tax interest it pays on the policy loan is less than the interest income being credited under the policy. In addition, tax-free death benefits that the company receives on the death of insured employees subsidize future years' premiums. The company is able to increase the value of its life insurance contract while using funds borrowed under the insurance contract for other purposes.<sup>5</sup> Large COLI programs could be viewed as the economic equivalent of a tax-free savings account owned by the company into which it pays itself tax-deductible interest.

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basis recovery first), and an additional ten percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances. A modified endowment contract is a life insurance contract that is funded more rapidly than seven annual level premiums.

<sup>3</sup> Solov, Diane, "Companies Profit By Insurance," St. Paul Pioneer Press, p. 2E, March 20, 1995. See also Sheppard, Lee, "'Janitor' Insurance as a Tax Shelter," Tax Notes, p. 1526, September 25, 1995.

<sup>4</sup> In some cases, state law provides that an employer continues to have an insurable interest in former employees even after the termination of their employment. Thus, this life insurance coverage may be continued after an employee terminates employment with an employer, creating an ever-increasing pool of lives.

<sup>5</sup> Companies sometimes use the funds borrowed under the life insurance contracts for tax-advantaged funding of expenses such as retiree health benefits and nuclear decommissioning expenses, even though Congress has already provided special tax benefits specifically for funding these expenses.

The limitations on borrowing with respect to a life insurance contract under present law provide that no deduction is allowed for any interest paid or accrued on any indebtedness with respect to one or more life insurance policies owned by the taxpayer covering the life of any individual who (1) is an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of such debt with respect to policies covering the individual exceeds \$50,000.

Further, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract.<sup>6</sup> An exception to the latter rule is provided, permitting deductibility of interest on bona fide debt that is part of such a plan, if no part of 4 of the annual premiums due during the first 7 years is paid by means of debt (the "4-out-of-7 rule"). Provided the transaction gives rise to debt for Federal income tax purposes, and provided the 4-out-of-7 rule is met, a company may under present law borrow up to \$50,000 per employee, officer, or financially interested person to purchase or carry a life insurance contract covering such a person, and is not precluded by the statutory disallowance rules from deducting the interest on the debt, even though the earnings inside the life insurance contract (inside buildup) are tax-free, and in fact the taxpayer has full use of the borrowed funds.

### **Description of Proposal**

Subject to an exception described below, the proposal would eliminate any deduction for any amount paid or accrued on any indebtedness with respect to life insurance, endowment or annuity policies owned by the taxpayer covering any individual who is either an officer or employee of, or financially interested in, any trade or business carried on by the taxpayer, regardless of the aggregate amount of debt with respect to policies covering the individual.

An exception would be provided retaining present law for interest on indebtedness with respect to life insurance policies covering up to 25 key persons. A key person would be an individual who is either an officer or a 20-percent owner of the taxpayer. The taxpayer could designate a number of key persons equal to the greater of 5 people or 5 percent of the number of officers and employees, but not more than 25. All members of a controlled group would be treated as one taxpayer for this purpose. Interest paid or accrued on debt with respect to a life insurance contract covering a key person would be deductible only if the rate of interest does not

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<sup>6</sup> The statute provides that the \$50,000 limitation does not apply with respect to contracts purchased on or before June 20, 1986. However, additional limitations are imposed by statute on the deductibility of interest with respect to single premium contracts, and on the deductibility of premiums paid on a life insurance contract covering the life of any officer or employee or person financially interested in a trade or business of the taxpayer when the taxpayer is directly or indirectly a beneficiary under the contract. In addition to statutory disallowance rules, generally applicable principles of tax law apply.

exceed Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month interest is paid or accrued.

### Effective Date

With respect to debt incurred after December 31, 1995, no deduction would be allowed except with respect to policies that satisfy the key man exception. In addition, as described below, a grandfather rule would be provided with respect to certain interests on indebtedness with respect to contracts issued on or before June 20, 1986.

With respect to debt incurred on or before December 31, 1995, any interest paid or accrued after October 13, 1995, and before January 1, 2001, would be allowed to the extent the rate of interest does not exceed the lesser of (1) the borrowing rate specified in the contract as of October 13, 1995, or (2) a percentage of Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month the interest is paid or accrued. For interest paid or accrued after October 13, 1995, and before January 1, 1997, the percentage of the Moody's rate would be 100 percent; for interest paid or accrued in 1997, the percentage would be 95 percent; for 1998, the percentage would be 90 percent; for 1999, the percentage would be 85 percent; for 2000, the percentage would be 80 percent; and for 2001 and thereafter, the percentage would be 0 percent.

Any amount included in income during 1996, 1997, 1998, 1999, 2000 or 2001, that is received under a contract described in the proposal on the complete surrender, redemption or maturity of the contract or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract, would be includable ratably over the first four taxable years beginning with the taxable year the amount would otherwise have been includable. Utilization of this 4-year income-spreading rule would not cause interest paid or accrued prior to January 1, 2001, to be nondeductible solely by reason of failure to meet the 4-out-of-7 rule.

In the case of an insurance company, the unamortized balance of policy expenses attributable to a contract with respect to which the 4-year income-spreading treatment is allowed to the policyholder would be deductible in the year in which the transaction giving rise to income-spreading occurs.

The proposal generally would not apply to interest on debt with respect to contracts purchased on or before June 20, 1986 (thus continuing the effective date provision of the \$50,000 limitation enacted in the 1986 Act), except that interest on such contracts paid or accrued after October 13, 1995 would be allowable only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month the interest is paid or accrued.

Under the proposal, there would be no inference as to the tax treatment of interest paid or accrued under present law.

#### **4. Phase-out preferential tax deferral for certain large farm corporations required to use accrual accounting**

##### **Present Law**

A corporation engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation, for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding \$1 million. If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period, beginning with the year of change. This rule does not apply to a family farm corporation.

A provision of the Revenue Act of 1987 ("1987 Act") requires a family corporation to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding \$25 million. A family corporation is one where 50 percent or more of the stock of the corporation is held by one (or in some limited cases, two or three) families.

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change.

The amount of the suspense account is required to be included in gross income if the corporation ceases to be a family corporation. In addition, if the gross receipts of the corporation attributable to farming for any taxable year decline to an amount below the lesser of (1) the gross receipts attributable to farming for the last taxable year for which an accrual method of accounting was not required, or (2) the gross receipts attributable to farming for the most recent taxable year for which a portion of the suspense account was required to be included in income, a portion of the suspense account is required to be included in gross income.

##### **Description of Proposal**

The proposal would repeal the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the proposal, any family farm corporation required to change to an accrual method of accounting would include in gross income the section 481 adjustment applicable to the change ratably over a 10-year period beginning with the year of change. In addition, any taxpayer with an existing suspense account would be required to include the account in income ratably over a 20-year period beginning in the first taxable year beginning after September 13, 1995, subject to the

present-law requirements to include all or a portion of the account in income more rapidly in certain instances.

### **Effective Date**

The proposal would be effective for taxable years ending after September 13, 1995.

## **5. Phaseout of section 936 credit**

### **Present Law**

Certain domestic corporations with business operations in the U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect the section 936 credit which generally eliminates the U.S. tax on certain income related to their operations in the possessions. In contrast to the foreign tax credit, the possessions tax credit is a "tax sparing" credit. That is, the credit is granted whether or not the electing corporation pays income tax to the possession. Income exempt from U.S. tax under this provision falls into two broad categories: (1) possession business income, which is derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business; and (2) qualified possession source investment income ("QPSII"), which is attributable to the investment in the possession or in certain Caribbean Basin countries of funds derived from the active conduct of a possession business.

In order to qualify for the section 936 credit for a taxable year, a domestic corporation must satisfy two conditions (sec.936(a)(2)). First, the corporation must derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation must derive at least 75 percent of its gross income for that same period from the active conduct of a possession business.

A domestic corporation that has elected the section 936 credit and that satisfies these two conditions for a taxable year generally is entitled to a credit equal to the U.S. tax attributable to the sum of the taxpayer's possession business income and its QPSII. However, the amount of the credit attributable to possession business income is subject to the limitations enacted by the Omnibus Budget Reconciliation Act of 1993 ("1993 Act") (sec. 936(a)(4)). Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes). In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage is phased down, beginning at 60 percent for 1994 and reaching 40 percent for 1998 and thereafter. The amount of the section 936 credit attributable to QPSII is not subject to these limitations.

## Description of Proposal

The proposal would limit the section 936 credit attributable to both possession business income and QPSII as described below. Except as described below with respect to existing facilities in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands, the section 936 credit would be eliminated for taxable years beginning after December 31, 2001.

For taxpayers using the economic activity limit enacted by the 1993 Act, the section 936 credit attributable to possession business income (determined under the economic activity limit) would continue to be determined as under present law through the taxpayer's taxable year beginning in 2001. For taxable years beginning in 2002 and thereafter, the section 936 credit attributable to possession business income (determined under the economic activity limit) would be eliminated.

For taxpayers that elected to use the applicable percentage limit and not to use the economic activity limit, the section 936 credit attributable to possession business income would continue to be determined as under present law through the taxpayer's taxable year beginning in 1998. For taxable years beginning during 1999, the section 936 credit attributable to possession business income (determined under the applicable percentage limitation) that would be allowed under the proposal would be limited to 75 percent of the amount that would otherwise be allowed. For taxable years beginning during 2000, the section 936 credit attributable to possession business income (determined under the applicable percentage limit) that would be allowed under the proposal would be limited to 50 percent of the amount that would otherwise be allowed. For taxable years beginning during 2001, the section 936 credit attributable to possession business income (determined under the applicable percentage limit) that would be allowed under the proposal would be limited to 25 percent of the amount that would otherwise be allowed. For taxable years beginning in 2002 and thereafter, the section 936 credit attributable to possession business income (determined under the applicable percentage limit) would be eliminated.

A taxpayer that elected to use the applicable percentage limit would be permitted to revoke that election for its taxable year beginning in 1996 and thereafter. A revocation must be made not later than for the taxable year beginning after December 31, 1995; such revocation, if made, would apply to such taxable year and to all subsequent taxable years.

For taxable years beginning in 1996 and thereafter, the section 936 credit attributable to QPSII would apply only to income attributable to investments made on or before October 13, 1995 (provided such income would otherwise qualify as QPSII under present law). For taxable years beginning after December 31, 1995, income attributable to investments made after October 13, 1995 would not be eligible for the section 936 credit. Income attributable to an investment made on or before October 13, 1995 (or to the reinvestment of the proceeds of such an investment) would be eligible for the section 936 credit attributable to QPSII through the date that such investment, if distributed, would be eligible for the maximum reduction in local taxes

(as determined under local law in effect as of October 13, 1995). However, the section 936 credit attributable to QPSII would be eliminated for taxable years beginning after December 31, 2000.

With respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands, the section 936 credit would be eliminated for taxable years beginning after December 31, 1995. However, special rules would apply with respect to the section 936 credit derived from existing operations in Guam, American Samoa, and the Northern Mariana Islands. For taxable years beginning before 2006, present law would continue to apply in determining the section 936 credit derived from operations conducted through existing facilities in such possessions. A facility would cease to qualify as an existing facility if a substantial new line of business is conducted through such facility after October 13, 1995; such a facility would cease to qualify as an existing facility as of the beginning of the taxable year during which the substantial new line of business is added. An existing facility would continue to qualify as an existing facility following a change of ownership of such facility (provided that a substantial new line of business is not conducted through such facility). For taxable years beginning in 2006 and thereafter, the section 936 credit with respect to such existing facilities would be eliminated.

#### **Effective Date**

The proposal would be effective on the date of enactment.

### **6. Corporate accounting--reform of income forecast method**

#### **Present Law**

##### **Depreciation and amortization, in general**

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through allowances for depreciation or amortization. Depreciation deductions are allowed under section 167 and the amounts of such deductions are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168 for most tangible property. MACRS determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Intangible property generally is amortized under section 197, which applies a 15-year recovery period and the straight-line method to the cost of applicable property.

##### **Treatment of film, video tape, and similar property**

MACRS does not apply to certain property, including (1) any motion picture film, video tape, or sound recording or (2) any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. Likewise, section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property unless acquired as part of a trade or business.

Thus, the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the general depreciation provision of section 167, which allows deductions for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property.

The "income forecast" method is an allowable method for calculating depreciation under section 167 for certain property. The income forecast method attempts to match allocable portions of the cost of property with the income expected to be generated by the property. Specifically, under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property<sup>7</sup> (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The income forecast method has been held to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings and video games.<sup>8</sup> The total forecasted or estimated income to be derived from a property is to be based on the conditions known to exist at the end of the period for which depreciation is claimed. This estimate can be revised upward or downward at the end of a subsequent taxable period based on additional information that becomes available after the last prior estimate. These revisions, however, do not affect the amount of depreciation claimed in a prior taxable year. Thus, unforeseen income that is generated after the property is fully depreciated is never taken into account under the income forecast method.

In the case of a film, income to be taken into account under the income forecast method means income from the film less the expense of distributing the film, including estimated income

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<sup>7</sup> In Transamerica Corp. v. U.S., 999 F.2d 1362, (9th Cir. 1993), the Ninth Circuit overturned the District Court and held that for purposes of applying the income forecast method to a film, the "cost of a film" includes "participation" and "residual" payments (i.e., payments to producers, writers, directors, actors, guilds, and others based on a percentage of the profits from the film) even though these payments were contingent on the occurrence of future events. It is unclear to what extent, if any, the Transamerica decision applies to amounts incurred after the enactment of the economic performance rules of Code section 461(h), as contained in the Deficit Reduction Act of 1984.

<sup>8</sup> See, e.g., Rev. Rul. 60-358, 1960-2 C.B. 68; Rev. Rul. 64-273, 1964-2 C.B. 62; Rev. Rul. 79-285, 1979-2 C.B. 91; and Rev. Rul. 89-62, 1989-1 C.B. 78. Conversely, the courts have held that certain tangible personal property was not of a character to which the income forecast method was applicable. See, e.g., ABC Rentals of San Antonio v. Comm., 68 TCM 1362 (1994) (consumer durable property subject to short-term, "rent-to-own" leases not eligible) and Carland, Inc. v. Comm., 90 T.C. 505 (1988), aff'd on this issue, 909 F.2d 1101 (8th Cir 1990) (railroad rolling stock subject to a lease not eligible).



from foreign distribution or other exploitation of the film.<sup>9</sup> In the case of a motion picture released for theatrical exhibition, income does not include estimated income from future television exhibition of the film (unless an arrangement for domestic television exhibition has been entered into before the film has been depreciated to its reasonable salvage value). In the case of a series or a motion picture produced for television exhibition, income does not include estimated income from domestic syndication of the series or the film (unless an arrangement for syndication has been entered into before the series or film has been depreciated to its reasonable salvage value).<sup>10</sup> The Internal Revenue Service also has ruled that income does not include net merchandising revenue received from the exploitation of film characters.<sup>11</sup>

### **Description of Proposal**

The proposal would make several amendments to the income forecast method of determining depreciation deductions.

First, the proposal would provide that income to be taken into account under the income forecast method includes all estimated income generated by the property. In applying this rule (and the look-back method described below), a taxpayer generally need not take into account income expected to be generated more than ten years after the year the property was placed in service. In addition, pursuant to a special rule, if a taxpayer produces a television series and initially does not anticipate syndicating the episodes from the series, the forecasted income for the episodes of the first three years of the series need not take into account any future syndication fees (unless the taxpayer enters into an arrangement to syndicate such episodes during such period). The 10-year rule and the syndication rule would apply for purposes of the look-back method described below.

In the case of a film, television show, or similar property, estimated income to be taken into account with respect to the property would include, but would not necessarily be limited to, income from foreign and domestic theatrical, television, and other releases and syndications; video tape releases, sales, rentals, and syndications; and the exploitation of film or program characters, prints, scripts, and scores. It is anticipated that income from the exploitation of film or program characters would, except as provided in regulations, generally be limited to income realized from licensing, rental, royalty and other similar arrangements with third parties with respect to such property and income from the sales of merchandise or other items that embody such characters.

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<sup>9</sup> Rev. Rul. 60-358, 1960-2 C.B. 68.

<sup>10</sup> Rev. Proc. 71-29, 1971-2 C.B. 568.

<sup>11</sup> Private letter ruling 7918012, January 24, 1979. Private letter rulings do not have precedential authority and may not be relied upon by any taxpayer other than the taxpayer receiving the ruling but are some indication of IRS administrative practice.

In addition, the cost of property subject to depreciation would only include amounts that satisfy the economic performance standard of section 461(h).<sup>12</sup> Any costs that are taken into account after the property is placed in service would be treated as a separate piece of property to the extent (1) such amounts are expected to give rise to significant future income not reasonably anticipated with respect to the property originally placed in service or (2) such costs are incurred more than 10 years after the property was placed in service. Except as provided in regulations, any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

Finally, taxpayers that claim depreciation deductions under the income forecast method would be required to pay (or would receive) interest based on the recalculation of depreciation under a "look-back" method.<sup>13</sup> The "look-back" method would be applied in any "recomputation year" by: (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in regulations, a "recomputation year" would be the third and tenth taxable year after the taxable year the property was placed in service unless the actual income from the property for each period before the close of such years was within 10 percent of the estimated income from the property for such periods. The Secretary of the Treasury would have the authority to allow a taxpayer to delay the initial application of the look-back method where the taxpayer may be expected to have significant income from the property after the third taxable year after the taxable year the property was placed in service (e.g., the Secretary may exercise such authority where the depreciable life of the property is expected to be longer than three years).<sup>14</sup> Property with an adjusted basis of \$100,000 or less when the property was placed in service would not be subject to the look-back method. The proposal would provide a simplified look-back method for pass-through entities.

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<sup>12</sup> No inference would be intended as to the proper application of section 461(h) to the income forecast method under present law.

<sup>13</sup> The "look-back" method of the proposal would resemble the look-back method applicable to long-term contracts accounted for under the percentage-of-completion method of present-law sec. 460. Interest paid or received under the look-back method of the proposal would be treated similarly to interest paid or received under sec. 460.

<sup>14</sup> In applying the look-back method, any cost that is taken into account after the property was placed in service may be taken into account by discounting (using the Federal mid-term rate determined under sec. 1274(d) as of the time the costs were taken into account) such cost to its value as of the date the property was placed in service.

### **Effective Date**

The proposal would be effective for property placed in service after September 13, 1995, unless placed in service pursuant to a binding written contract in effect before such date and all times thereafter.

## **7. Allow amortization for intrastate operating rights of motor carriers**

### **Present Law and Background**

A taxpayer is allowed to write-off and deduct the adjusted basis of property used in trade or business when such property becomes worthless (sec. 165). A write-off is not allowed if the property merely loses value but does not become worthless. For example, in CRST, Inc., 909 F2d. 1146, (8th Cir. 1990), a motor carrier was denied a worthlessness deduction for the basis of operating authorities that had become less valuable, but not worthless, due to deregulation.

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

### **Description of Proposal**

The proposal would allow a taxpayer who held, on January 1, 1995, an operating authority that was preempted by section 601 of the Federal Aviation Administration Authorization Act of 1994 to amortize the adjust basis of such authority ratably over a 36-month period. No other deduction would be allowed with respect to such property.

### **Effective Date**

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

## **8. Permit corporate pension transfers to fund employee benefits**

### **Present Law**

#### **Pension plan funding**

Present law imposes minimum funding requirements on employers sponsoring a defined benefit pension plan which are designed to provide at least a certain level of benefit security by requiring the employer to make certain minimum contributions to the plan.

Within limits, an employer is permitted to make contributions in excess of the minimum funding requirements. Making contributions in excess of those required by the minimum funding

requirements, as well as other factors, such as greater investment returns than assumed for funding purposes, can contribute to overfunding of pension plans.

Contributions to a plan are no longer deductible by the employer when plan assets reach a certain level, called the full-funding limit. Contributions in excess of the full-funding limit are also subject to a 10-percent excise tax. A plan has reached the full-funding limit if the level of plan assets exceeds the lesser of (1) 150 percent of current liability, or (2) the accrued liability under the plan. In general terms, "current liability" is the amount of plan assets needed to fund all current accrued benefits under the plan to date (vested and nonvested). Current liability is determined using a statutorily prescribed interest rate assumption--the interest rate used must be between 90 and 110 percent of the four-year weighted average 30-year Treasury rate. As under the general minimum funding rules, other actuarial assumptions used to calculate current liability are required to be reasonable. Accrued liability is generally the amount of assets required to fund the plan under the actuarial funding method used by the plan.

### **Transfers of excess pension assets**

Under present law, defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. Any assets that revert to the employer upon such termination are includible in the gross income of the employer and subject to an excise tax. The rate of the excise tax generally is 20 percent, and is increased to 50 percent unless the employer maintains a replacement plan or makes certain benefit increases in connection with the plan termination. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

The Omnibus Budget Reconciliation Act of 1990 included a provision under which employers could transfer excess assets in an overfunded pension plan to pay certain retiree health liabilities. Provided certain requirements are satisfied, such a transfer does not affect a plan's tax-qualified status and is not a prohibited transaction. Further, the assets transferred are not includible in the gross income of the employer and are not subject to the excise tax on reversions. The employer is not entitled to deduct retiree health benefits paid with transferred assets.

A transfer must satisfy certain requirements designed to protect the benefit security of plan participants. Under one of these requirements, the accrued retirement benefits of participants under the pension plan (including participants who separated from service during the 1-year period ending on the date of the transfer) must be nonforfeitable as if the plan terminated immediately before the transfer. In addition, only excess pension assets may be transferred. Excess pension assets are defined to be the excess of the value of plan assets over the greater of (1) the plan's full funding limit, or (2) 125 percent of current liability. As described above, the first part of this standard is the same as the maximum limit for making contributions to the plan for deduction purposes. As under that limit, the interest rate used in calculating current liability for the 125 percent asset cushion must be between 90 and 110 percent of the four-year weighted average 30-year Treasury rate. The second part only applies if current liability is greater than the full funding limit. Thus, a transfer can only be made from a plan that is at the full funding limit

and is no longer permitted to receive deductible contributions.

If any amount transferred is not used to pay retiree health expenses, such amount must be transferred back to the pension plan. Such amounts transferred back are not includible in the employer's income, but are subject to the 20-percent excise tax on reversions.

The provision permitting certain transfers of excess pension assets was originally adopted for a 5-year period, through 1995. The excess pension assets transfer provision was extended through the year 2000 by the Retirement Protection Act of 1994, which was enacted as part of the Uruguay Round Agreements Act (commonly referred to as the implementing legislation for the General Agreement on Tariffs and Trade ("GATT")). The GATT legislation did not change the way in which excess pension assets are calculated.

### **Description of Proposal**

The proposal would modify the circumstances under which employers may transfer excess assets from a defined benefit pension plan. The proposal would permit a qualified transfer of excess assets from a defined benefit pension plan (other than a multiemployer plan) to the employer, provided such assets are used to pay for qualified employee benefits provided by the employer. Qualified employee benefits would be defined as qualified retirement plan benefits, accident and health benefits, disability benefits, educational assistance, and dependent care assistance. Such benefits are provided under plans which cover a broad group of employees, and are subject to regulation under the Internal Revenue Code and the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). For example, excess pension assets could be transferred from an overfunded pension plan maintained by an employer to an underfunded pension plan maintained by the same employer.

The total amount of excess pension assets which could be transferred in qualified transfers during any year could not exceed the amount the employer pays during the year of transfer for qualified employee benefits. In addition, in order for the transfer to be qualified, the accrued retirement benefits of participants (including participants who separated from service during the 1-year period ending on the date of the transfer) under the pension plan must be nonforfeitable as if the plan terminated immediately before the transfer.

Amounts transferred would be includible in the gross income of the employer. Except as described below, no excise tax would apply to the amount transferred in a qualified transfer. There would be no limit on the number of qualified transfers that could be made during any taxable year. As under present law, a qualified transfer under the proposal would not affect the plan's qualified status and would not be a prohibited transaction.

Excess pension assets would be defined as under present law, and would be determined as of whichever of the following dates excess pension assets are lower: (1) January 1, 1995 (or, if January 1, 1995, is not a plan valuation date, as of the last plan valuation date preceding January 1, 1995), or (2) the most recent plan valuation date preceding the transfer.

The present-law rules would apply with respect to transferred amounts that are not used to pay for qualified employee benefits for the year of transfer. Thus, any such amount income would have to be returned to the pension plan. Amounts returned would not be includible in the gross income of the employer, but would be subject to the 20-percent excise tax on reversions. No deduction would be allowed with respect to returned amounts.

As under present law, the proposal would not apply to transfers in taxable years beginning after December 31, 2000.

### **Effective Date**

The proposal would be effective with respect to transfers on or after the date of enactment.

## **9. Modify exclusion of damages received on account of personal injury or sickness**

### **Present Law**

Under present law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness (sec. 104(a)(2)).

The exclusion from gross income of damages received on account of personal injury or sickness specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Courts presently differ as to whether the exclusion applies to damages received in connection with a case involving a physical injury or physical sickness.

Courts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. The damages received in these cases generally consist of back pay and other awards intended to compensate the claimant for lost wages or lost profits. The Supreme Court recently held that damages received based on a claim under the Age Discrimination in Employment Act could not be excluded from income. In light of the Supreme Court decision, the Internal Revenue Service has suspended existing guidance on the tax treatment of damages received on account of other forms of employment discrimination.

### **Description of Proposals**

#### **Include in income all punitive damages**

The proposal would provide that the exclusion from gross income does not apply to any punitive damages received on account of personal injury or sickness whether or not related to a

physical injury or sickness. No inference would be intended as to the application of the exclusion to punitive damages received prior to the effective date of this proposal in connection with a case involving a physical injury or sickness.

### **Include in income damage recoveries for nonphysical injuries**

The proposal would provide that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom would be treated as payments involving physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse would be excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death would continue to be excludable from income as under present law.

The proposal also would provide that emotional distress is not considered a physical injury or physical sickness. Thus, the exclusion from gross income would not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income would apply to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income would apply to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

### **Effective Date**

The proposals generally would be effective with respect to amounts received after December 31, 1995. The proposals would not apply to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

## **10. Require tax reporting for payments to attorneys**

### **Present Law**

Information reporting is required by persons engaged in a trade or business and making payments in the course of that trade or business of "rent, salaries, wages, ... or other fixed or determinable gains, profits, and income" (Code sec. 6041(a)). Treas. Reg. sec. 1.6041-1(d)(2) provides that attorney's fees are required to be reported if they are paid by a person in a trade or business in the course of a trade or business. Reporting is required to be done on Form 1099-Misc. If, on the other hand, the payment is a gross amount and it is not known what portion is the attorney's fee, no reporting is required on any portion of the payment.

## **Description of Proposal**

The proposal would require gross proceeds reporting on all payments to attorneys made by a trade or business in the course of that trade or business. It is anticipated that gross proceeds reporting would be required on Form 1099-B (currently used by brokers to report gross proceeds). The only exception to this new reporting requirement would be for any payments reported on either Form 1099-Misc under section 6041 (reports of payment of income) or on Form W-2 under section 6051 (payments of wages).

In addition, the present exception in the regulations exempting from reporting any payments made to corporations would not apply to payments made to attorneys. Treas. Reg. sec. 1.6041-3(c) exempts payments to corporations generally (although payments to most corporations providing medical services must be reported). Reporting would be required under both 6041 and 6045 (as proposed) for payments to corporations that provide legal services. The exception of Treas. Reg. sec. 1.6041-3(g) exempting from reporting payments of salaries or profits paid or distributed by a partnership to the individual partners would continue to apply to both sections (since these amounts are required to be reported on Form K-1).

## **Effective Date**

The proposal would be effective for payments made after December 31, 1995. Consequently, the first information reports would be filed with the IRS (and copies would be provided to recipients of the payments) in 1997, with respect to payments made in 1996.

- 11. Disallow rollover under section 1034 to extent of previously claimed depreciation for home office or other depreciable use of residence**

## **Present Law**

### **Rollover**

Generally, no gain is recognized on the sale of a principal residence to the extent that the amount of the sales price of the old residence is reinvested in a new residence within a specified period. The specified period generally is a period beginning two years before the sale of the old residence and ending two years after the sale of the old residence.

### **One-time exclusion**

In general, a taxpayer may exclude from gross income up to \$125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has used the residence as a principal residence for at least three of the five years preceding the sale. This election is allowed only once in a lifetime unless all previous elections are revoked.

In the case of a mixed use of a residence, the exclusion is limited only to that portion of



the residence that is owned and used by the individual as his principal residence for at least three of the previous five years before the date of sale. Gain on the portion not qualifying as a principal residence is not eligible for this exclusion.

### **Description of Proposal**

#### **Rollover**

The proposal would provide that gain shall be recognized on the sale of a principal residence to the extent of any depreciation allowable with respect to such principal residence for periods after December 31, 1995.

#### **One-time exclusion**

The proposal would impose an additional restriction on the availability of the one-time exclusion. Specifically, the amount of the otherwise allowable one-time exclusion would be reduced (and therefore the amount of recognized gain would be increased) to the extent of depreciation allowable with respect to such principal residence for periods after December 31, 1995.

### **Effective Date**

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

12. **Provide that rollover of gain on sale of a principal residence cannot be elected by a resident alien unless the replacement property purchased is located within the United States**

### **Present Law**

Generally, no gain is recognized on the sale or exchange of a principal residence to the extent that the amount of the sales price of the old residence is reinvested in a new residence within a specified period ("the rollover"). The specified period generally is a period beginning two years before the sale of the old residence, and ending two years after the sale of the old residence. There is no requirement that either the old residence or new residence be located within the United States or its possessions.

### **Description of Proposal**

Generally, the proposal would require the recognition of gain on the sale of a principal residence by a resident alien unless the resident alien (1) retains resident alien status for at least two years after the date of sale, (2) becomes a U.S. citizen within two years of the date of sale, or (3) acquires a new residence located in the U.S. or its possessions within the specified time period.

The proposal would not apply where (1) the old residence is held jointly by the resident alien and the resident alien's spouse, (2) they file a joint tax return, and (3) the spouse is a U.S. citizen on the date of sale of the old residence.

#### **Effective Date**

The proposal would apply to the sale of old residences after December 31, 1995, unless a new residence was purchased before September 13, 1995, or purchased on or after such date pursuant to a binding contract in effect on such date and at all times thereafter before such purchase.

### **13. Repeal exemption for withholding on gambling winnings from bingo and keno where proceeds exceed \$5,000**

#### **Present Law**

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

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

No withholding tax is imposed on winnings from bingo or keno.

#### **Description of Proposal**

The proposal would impose withholding on proceeds from bingo or keno wagering transactions at a rate of 28 percent if such proceeds exceed \$5,000, regardless of the odds of the wager.

#### **Effective Date**

The proposal would be effective on January 1, 1996.

### **14. Repeal advance refunds of diesel fuel tax for diesel cars and light trucks**

#### **Present Law**

Excise taxes are imposed on gasoline (14 cents per gallon) and diesel fuel (20 cents per gallon) to fund the Federal Highway Trust Fund. Before 1985, the gasoline and diesel fuel tax

rates were the same. The predominate highway use of diesel fuel is by trucks. In 1984, the diesel fuel excise tax rate was increased above the gasoline tax as the revenue offset for a reduction in the annual heavy truck use tax. Because automobiles, vans, and light trucks, did not benefit from the use tax reductions, a provision was enacted allowing first purchasers of model year 1979 and later diesel-powered automobiles and light trucks a tax credit to offset this increased diesel fuel tax. The credit is \$102 for automobiles, and \$198 for vans and light trucks.

#### **Description of Proposal**

The tax credit for purchasers of diesel-powered automobiles and light trucks would be repealed.

#### **Effective Date**

The proposal would be effective for vehicles purchased after December 31, 1995.

### **15. Apply failure to pay penalty to substitute returns**

#### **Present Law**

Section 6651(a)(2) provides that the IRS may assess a penalty for failure to pay tax from the due date of the return until the tax is paid. If no return is filed by the taxpayer and the IRS files a substitute return under section 6020, the tax on which the penalty is measured is considered a deficiency assessable under section 6212 or 6213, and the failure to pay penalty begins to accumulate ten days after the IRS sends the taxpayer a notice and demand for payment of the tax.

#### **Description of Proposal**

The proposal would apply the failure to pay penalty to substitute returns in the same manner as the penalty applies to delinquent filers.

#### **Effective Date**

The proposal would apply in the case of any return the due date for which (determined without regard to extensions) is after the date of enactment.

## 16. Modify treatment of foreign trusts

### Present Law

#### Income taxation of trusts and their beneficiaries

##### Taxation of trusts

A trust is treated as a separate taxable entity, except in cases where the grantor (or a person with a power to revoke the trust) has certain powers with respect to the trust (discussed below). A trust generally is taxed like an individual with certain modifications. These modifications include: (1) a separate tax rate schedule applicable to estates and trusts; (2) an unlimited charitable deduction for amounts paid to charity; (3) a personal exemption of \$300 for a trust that is required to distribute all of its income currently, or \$100 for any other trust; (4) no standard deduction for trusts; and (5) a deduction for distributions to beneficiaries. A trust is required to use the calendar year as its taxable year. Trusts generally are required to pay estimated income tax.

##### Taxation of distributions to beneficiaries

Distributions from a trust to a beneficiary generally are includible in the beneficiary's gross income to the extent of the distributable net income ("DNI") of the trust for the taxable year ending with, or within, the taxable year of the beneficiary. DNI is taxable income (1) increased by any tax-exempt income (net of disallowed deductions attributable to such income), and (2) computed without regard to personal exemptions, the distribution deduction, capital gains that are allocated to corpus and are neither distributed to any beneficiary during the taxable year nor set aside for charitable purposes, capital losses other than capital losses taken into account in determining the amount of capital gains which are paid to beneficiaries, and (with respect to simple trusts) extraordinary dividends which are not distributed to beneficiaries (sec. 643). The exclusion for small business capital gains under section 1202 is not taken into account in determining DNI.

Distributions to trust beneficiaries out of previously accumulated income are taxed to the beneficiaries under a throwback rule (sec. 667). The effect of the throwback rule is to impose an additional tax on the distribution of previously accumulated income in the year of distribution at the beneficiary's average marginal rate for the 5 years prior to the distribution. The amount of the distribution is grossed-up by the amount of the taxes paid by the trust on the accumulated income and a nonrefundable credit is allowed to the beneficiary for such taxes. In order to prevent trusts from accumulating income for a year, the fiduciary of a trust may elect to treat distributions within the first 65 days after the close of its taxable year as having occurred at the end of the preceding taxable year.

If a trust makes a loan to one of its beneficiaries, the principal of such a loan is generally not taxable as income to the beneficiary.

### Grantor trust rules

Under the grantor trust rules (secs. 671-679), the grantor of a trust will continue to be taxed as the owner of the trust (or a portion thereof) if it retains certain rights or powers. A grantor of a trust generally is treated as the owner of any portion of a trust when the following circumstances exist:

(1) The grantor has a reversionary interest that has more than a 5-percent probability of returning to the grantor.

(2) The grantor has power to control beneficial enjoyment of the income or corpus. Certain powers are disregarded for this purpose--(a) a power to apply income to support a dependent; (b) a power affecting beneficial enjoyment that can be exercised only after an event that has a 5 percent or less probability of occurring; (c) a power exercisable only by will; (d) a power to allocate among charities; (e) a power to distribute corpus under an ascertainable standard or as an advancement; (f) a power to withhold income temporarily; (g) a power to withhold income during disability; (h) a power to allocate between corpus and income; (i) a power to distribute, apportion, or accumulate income or corpus among a class of beneficiaries that is held by an independent trustee or trustees; and, (j) a power to distribute, apportion, or accumulate income among beneficiaries that is limited by an ascertainable standard.

(3) The grantor retains any of the following administrative powers--(a) a power to deal at non-arms' length; (b) a power to borrow trust funds without adequate interest or security; (c) a borrowing that extends over one taxable year; (d) a power to vote stock of a controlled corporation held in the trust; (e) a power to control investment of trust funds in a controlled corporation; and (f) a power to reacquire trust corpus by substituting property with equivalent value.

(4) The grantor has a power to revoke, unless such power may not be exercised any time before an event that has a 5-percent or less probability of occurring.

(5) The income is or may be distributed to, held for the future benefit of, or used to pay for life insurance on the lives of, the grantor or the grantor's spouse, unless such power may not be exercised any time before an event that has a 5-percent or less probability of occurring. (An exception is provided for income that may be used to discharge an obligation of support, unless the income is so used.)

If the grantor is not treated as the owner of any portion of a trust, another person generally will be treated as the owner of that portion of the trust if he or she has the power to revoke that portion of the trust or gave up a power to revoke and retained any of the powers set forth above, unless the retained power is disclaimed within a reasonable time.

Under the grantor trust rules, a U.S. person who transfers property to a foreign trust generally is treated as the owner of the portion of the trust comprising that property for any

taxable year in which there is a U.S. beneficiary of any portion of the trust. This treatment generally does not apply, however, to transfers by reason of death, to sales or exchanges of property at fair market value where gain is recognized to the transferor, or to transfers made before the transferor became a U.S. person (sec. 679).

#### Payments from foreign trusts through nominees

Under a special rule, intermediaries or nominees interposed between certain foreign trusts and their beneficiaries are disregarded. This special rule treats any amount paid from a foreign person to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust that was created by a U.S. person, as if paid to the recipient directly by the foreign trust (sec. 665(c)).

#### Grantor trusts established by non-U.S. persons

Under the grantor trust rules, a grantor generally is treated as the owner of the trust's assets without regard to whether the grantor is a domestic or foreign person. Under these rules, U.S. trust beneficiaries can avoid U.S. tax on distributions from a trust where a foreign grantor is treated as owner of the trust, even though no tax may be imposed on the trust income by any jurisdiction.<sup>15</sup>

A special rule applies in the case of a grantor trust with a U.S. beneficiary, where the grantor trust rules otherwise would treat a foreign person as the owner of a portion of the trust, and the U.S. beneficiary had made gifts at any time, directly or indirectly, to the foreign person. In such a case, the U.S. beneficiary generally is treated as the grantor and owner of that portion to the extent of the gifts to the foreign person (sec. 672(f)).

#### Foreign trusts that are not grantor trusts

In cases where the grantor trust rules do not apply to a foreign trust, its U.S. beneficiaries generally are taxable on their respective shares of the income of the trust that is required to be distributed, as well as any other income of the trust that is paid, credited, or distributed to them (secs. 652, 662). Distributions from a trust in excess of the trust's distributable net income<sup>16</sup> for the taxable year generally are treated as accumulation distributions (sec. 665(b)), subject to the throwback rules. Under these rules, a distribution by a foreign trust of previously accumulated income generally is taxed at the beneficiary's average marginal rate for the prior 5 years, plus interest (secs. 666, 667). Interest is computed at a fixed annual rate of 6 percent, with no compounding (sec. 668).

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<sup>15</sup> See Rev. Rul. 69-70, 1969-1 C.B. 182.

<sup>16</sup> In the case of a foreign trust, DNI also includes foreign-source income net of related deductions, income that is exempt under treaties, and capital gains reduced (but not below zero) by capital losses.

If adequate records of the trust are not available to determine the proper application of the rules relating to accumulation distributions to any distribution from a trust, the distribution is treated as an accumulation distribution out of income earned during the first year of the trust (sec. 666(d)).

### Residence of estates and trusts

An estate or trust is treated as foreign if it is not subject to U.S. income taxation on its income that is neither derived from U.S. sources nor effectively connected with the conduct of a trade or business within the United States (sec. 7701(a)(31)). Thus, if a trust is taxed in a manner similar to a nonresident alien individual, it is considered to be a foreign trust. Any other estate or trust is treated as domestic (sec. 7701(a)(30)).

The Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien individual. Internal Revenue Service ("IRS") rulings and court cases, however, indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries.<sup>17</sup> If an examination of these factors indicates that a trust has sufficient foreign contacts, it is deemed comparable to a nonresident alien individual and, thus, is a foreign trust.

Section 1491 generally imposes a 35-percent excise tax on a U.S. person that transfers appreciated property to certain foreign entities, including a foreign trust.<sup>18</sup> In the case of a domestic trust that changes its situs and becomes a foreign trust, it is unclear whether property has been transferred from a U.S. person to a foreign entity, and, thus, whether the transfer is subject to section 1491.

### Information reporting requirements and associated penalties

Any U.S. person who creates a foreign trust or transfers money or property to a foreign trust is required to report that event to the IRS (sec. 6048(a)). Current regulations require reporting of, inter alia, the name, address and identification number (if any) of the transferor, the trust, the fiduciary and trust beneficiaries; the interest of each beneficiary; the location of the trust records; and the value of each item transferred (Treas. Reg. sec. 16.3-1(c)). Similarly, any U.S. person who transfers property to a foreign trust that has one or more U.S. beneficiaries is required to report annually to the IRS (sec. 6048(c)). In addition, if the transfer of any

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<sup>17</sup> For example, see Rev. Rul. 87-61, 1987-2 C.B. 219, Rev. Rul. 81-112, 1981-1 C.B. 598, Rev. Rul. 60-181, 1960-1 C.B. 257, and B.W. Jones Trust v. Commissioner, 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4th Cir. 1943).

<sup>18</sup> In Rev. Rul. 87-61 the IRS held that a U.S. citizen who transferred appreciated property to a foreign grantor trust is not subject to the section 1491 excise tax because the grantor continues to own the property for income tax purposes.

appreciated property by a U.S. person is subject to section 1491, the transferor is required to report the transfer to the IRS (Treas. Reg. sec. 1.1494-1(a)).

Any person who fails to file a required report with respect to the creation of, or a transfer to, a foreign trust may be subjected to a penalty of 5 percent of the amount transferred to the foreign trust (sec. 6677). Similarly, any person who fails to file a required annual report with respect to a foreign trust with U.S. beneficiaries may be subjected to a penalty of 5 percent of the value of the corpus of the trust at the close of the taxable year. The maximum amount of the penalty imposed under either case may not exceed \$1,000. A reasonable cause exception is available. These civil penalties are determined separately from any applicable criminal penalties.

### **Description of Proposals**

#### **a. Inbound foreign grantor trust rules**

##### **Foreign grantors not treated as owners**

Under the proposal, the grantor trust rules generally would apply only to the extent that they result, directly or indirectly, in amounts being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. Thus, the grantor trust rules generally would not apply to any portion of a trust where their effect would be to treat a foreign person as owner of that portion. The proposal would provide certain exceptions to this general rule. The proposal generally would not apply in the case of revocable trusts and trusts where the only amounts distributable during the lifetime of the grantor are to the grantor or the grantor's spouse. These exceptions would not apply to the extent of gifts made by a U.S. beneficiary of the trust to the foreign grantor. The proposal also would not apply to trusts established to pay compensation, and certain trusts in existence as of September 19, 1995.<sup>19</sup> In addition, the proposal generally would not apply where the grantor is a controlled foreign corporation, foreign personal holding company or passive foreign investment company.

In a case where the foreign grantor, who would be treated as the owner of the trust but for the above rule, actually pays tax on the income of the trust to a foreign country, it is anticipated that Treasury regulations would provide that U.S. beneficiaries who are subject to U.S. income tax on that income would be treated for foreign tax credit purposes as having paid the foreign taxes that were paid by the foreign grantor. Any resulting foreign tax credits would be subject to applicable foreign tax credit limitations.

The proposal would provide a transition rule for any domestic trust that has a foreign grantor who is treated as the owner of the trust under present law. If such a trust becomes a foreign trust before January 1, 1997, or if the assets of such a trust are transferred to a foreign trust before that date, such trust would be exempt from the excise tax on transfers to a foreign

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<sup>19</sup> The exception would not apply to the portion of any such trust attributable to any transfers made after September 19, 1995.



trust otherwise imposed by section 1491. However, the proposal's new reporting requirements and penalties would be applicable.

### **Distributions by foreign trusts through nominees**

The proposal would treat any amount paid to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust of which the payor is not the grantor, as if paid by the foreign trust directly to the U.S. person. This rule would disregard the role of an intermediary or nominee that may be interposed between a foreign trust and a U.S. beneficiary. Unlike present law, however, the rule would apply whether or not the trust was created by a U.S. person. The rule would not apply to a withdrawal from a foreign trust by its grantor, with a subsequent gift or other payment to a U.S. person.

### **Effective date**

The proposal would be effective on the date of enactment.

#### **b. Foreign trusts that are not grantor trusts**

### **Interest charge on accumulation distributions**

The proposal would change the interest rate applicable to accumulation distributions from foreign trusts from simple interest at a fixed rate of 6 percent to compound interest determined in the manner of the interest imposed on underpayments of tax under section 6621(a)(2). Simple interest would continue to accrue at the rate of 6 percent through 1995. Beginning on January 1, 1996, however, compound interest based on the underpayment rate would be imposed not only on tax amounts determined under the accumulation distribution rules but also on the total simple interest for pre-1996 periods, if any. For purposes of computing the interest charge, the accumulation distribution would be allocated proportionately to prior trust years in which the trust has undistributed net income (and the beneficiary receiving the distribution was a U.S. citizen or resident), rather than to the earliest of such years. An accumulation distribution would be treated as reducing proportionately the undistributed net income for such years.

The proposal would include an anti-abuse rule which authorizes the Secretary of the Treasury to issue regulations that may be necessary or appropriate to carry out the purposes of the rules applicable to accumulation distributions, including regulations to prevent the avoidance of those purposes.

## **Loans to grantors or beneficiaries**

In the case of a loan of cash or marketable securities by the foreign trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such grantor or beneficiary<sup>20</sup>), the proposal would treat the full amount of the loan as distributed to the grantor or beneficiary, even if the loan bears interest at an adequate rate and is subsequently repaid. In addition, any subsequent transaction between the trust and the original borrower regarding the principal of the loan (e.g., repayment) would be disregarded for all purposes of the Code.

## **Effective date**

The proposal to modify the interest charge on accumulation distributions would apply to distributions after the date of enactment. The Secretary of the Treasury would be authorized to issue regulations in the case of anti-abuse transactions; such regulations would be effective on the date of enactment. The proposal with respect to loans to U.S. grantors or U.S. beneficiaries would apply to loans made after September 19, 1995.

### **c. Outbound foreign grantor trust rules**

The proposal would make several modifications to the rules of section 679 under which foreign trusts with U.S. grantors and U.S. beneficiaries are treated as grantor trusts.

## **Sale or exchange at market value**

Present law contains an exception from grantor trust treatment for property transferred by a U.S. person to a foreign trust in the form of a sale or exchange at fair market value where gain is recognized to the transferor. In determining whether the trust paid fair market value to the transferor, the proposal would provide that obligations issued (or, to the extent provided by regulations, guaranteed) by the trust, by any grantor or beneficiary of the trust, or by any person related to a grantor or beneficiary<sup>21</sup> generally would not be taken into account except as provided in regulations.

## **Other transfers**

Under the proposal, a transfer of property to certain charitable trusts would be exempt from the application of the rules treating foreign trusts with U.S. grantors and U.S. beneficiaries

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<sup>20</sup> For this purpose, a person generally would be treated as related to the grantor or beneficiary if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under section 267 or 707(b).

<sup>21</sup> For this purpose, a person generally would be treated as related to the grantor or beneficiary if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under section 267 or 707(b).

as grantor trusts.

### **Transferors or beneficiaries who become U.S. persons**

The proposal would apply the rules of section 679 to certain foreign persons who transfer property to a foreign trust and subsequently become U.S. persons. A nonresident alien individual who transfers property, directly or indirectly, to a foreign trust and then becomes a resident of the United States within 5 years after the transfer generally would be treated as making a transfer to the foreign trust at the time the individual becomes a U.S. resident. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally would be treated under the rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. The proposal's new reporting requirements and penalties (discussed below) also would be applicable.

Under the proposal, a beneficiary would not be treated as a U.S. person for purposes of determining whether the transferor of property to a foreign trust would be taxed as a grantor with respect to any portion of a foreign trust if such beneficiary first became a U.S. resident more than 5 years after the transfer.

### **Outbound trust migrations**

The proposal would apply the rules of section 679 to a U.S. person that transferred property to a domestic trust if the trust subsequently became a foreign trust while the transferor was still alive. Such a person would be deemed to make a transfer to the foreign trust on the date of the migration. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally would be treated under the rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. The proposal's reporting requirements and penalties (discussed below) also would be applicable.

### **Effective date**

The proposals would apply to transfers of property after February 6, 1995.

#### **d. Residence of estates and trusts**

### **Treatment as U.S. person**

The proposal would establish a two-part objective test for determining for tax purposes whether a trust is foreign or domestic. If both parts of the test are satisfied, the trust would be treated as domestic. Only the first part of the test would apply to estates.

Under the first part of the proposed test, in order for an estate or trust to be treated as domestic, a U.S. court (i.e., Federal, State, or local) must be able to exercise primary supervision over the administration of the estate or trust. It is expected that this test would be satisfied by any trust instrument that specifies that it is to be governed by the laws of any State. In addition, an estate or trust may be able to subject itself voluntarily to the jurisdiction of a U.S. court through registration of the estate or trust under a State law similar to Article VII of the American Law Institute's Uniform Probate Code.

Under the second part of the proposed test, in order for a trust to be treated as domestic, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust. It is expected that this test would be satisfied in any case where fiduciaries who are U.S. persons hold a majority of the fiduciary power (whether by vote or otherwise), and where no foreign fiduciary, such as a "trust protector" or other trust advisor, has the power to veto important decisions of the U.S. fiduciaries. It is further expected that, in applying this test, a reasonable period of time would be allowed for a trust to replace a U.S. fiduciary who resigns or dies before the trust would be treated as foreign.

Under the proposal, a foreign estate would be defined as an estate other than an estate that is determined to be domestic under the court-supervision test. A foreign trust would be defined as a trust other than a trust that is determined to be domestic under both the court-supervision test and the U.S. fiduciary test.

### **Outbound migration of domestic trusts**

Under the proposal, if a domestic trust changes its situs and becomes a foreign trust, the trust would be treated as having made a transfer of its assets to the foreign trust and would be subject to the 35-percent excise tax imposed by present-law section 1491 unless one of the exceptions to this excise tax were applicable. In addition, the U.S. grantor would be required to report the transfer under the reporting requirements described below. Failure to report such a transfer would result in penalties (discussed below).

### **Effective date**

The proposal to modify the treatment of a trust or estate as a U.S. person would apply to taxable years beginning after December 31, 1996. In addition, if the trustee of a trust so elects, the proposal would apply to taxable years ending after the date of enactment. The proposed amendment to section 1491 would be effective on the date of enactment.

### **e. Information reporting relating to foreign trusts**

The proposal would expand the reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The proposal would require the responsible parties to file the designated information reports with

the IRS upon the occurrence of certain events. A failure to comply with the reporting requirements would result in increased monetary penalties under the proposal.

### **Information reporting requirements**

First, the proposal would require the grantor, transferor or executor (i.e., the "responsible party") to notify the IRS upon the occurrence of certain reportable events. The reportable events include direct and indirect transfers of property to a foreign trust and the death of a U.S. citizen or resident if any portion of a foreign trust was included in the gross estate of the decedent. The required notice would identify the money or other property transferred and report information regarding the trustee and beneficiaries of the foreign trust.

Second, a U.S. person that is treated as the owner of any portion of a foreign trust would be required to ensure that the trust files an annual report to provide full accounting of all the trust activities for the taxable year, the name of the U.S. agent for the trust, and other information as prescribed by the Secretary of the Treasury.<sup>22</sup> In addition, unless a U.S. person is authorized to accept service of process as the trust's limited agent with respect to with any request by the IRS to examine records or to take testimony and any summons for such records or testimony in connection with the tax treatment of any items related to the trust, the IRS would be entitled to determine, in its sole discretion, the amount to be taken into account under the grantor trust rules (secs. 671 through 679). This limited agency relationship would not constitute an agency relationship for any other purpose under Federal or State law.

Third, any U.S. person who receives (directly or indirectly) any distribution from a foreign trust would be required to file a notice to report the name of the trust, the aggregate amount of the distributions received, and other information that the Secretary of the Treasury may prescribe.

### **Monetary penalties for failure to report**

Under the proposal, a person who fails to provide the required notice in cases involving the transfer of property to a new or existing foreign trust, or a distribution by a foreign trust to a U.S. person, would be subject to an initial penalty equal to 35 percent of the gross reportable amount. A failure to provide an annual reporting of trust activities would result in an initial penalty equal to 5 percent of the gross reportable amount. In cases involving a transfer of property to a foreign trust, the gross reportable amount would be the gross value of the property transferred. In cases involving the death of a U.S. citizen or resident whose estate includes any portion of a foreign trust, the gross amount would be the value of the property includible in the gross estate of the decedent. In cases where annual reporting of trust activities is required, the gross reportable amount would be the gross value of the portion of the foreign trust's assets

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<sup>22</sup> It is intended that the regulations would require the trust to furnish information to U.S. grantors and beneficiaries concerning income reportable by such persons that is similar to the items on schedule K-1 of Form 1041.

treated as owned by the U.S. grantor at the close of the year, and in cases involving a distribution to a U.S. beneficiary of a foreign trust, the gross reportable amount would be the amount of the distribution to the beneficiary. An additional \$10,000 penalty would be imposed for continued failure for each 30-day period (or fraction thereof) beginning 90 days after the IRS notifies the responsible party of such failure. Such penalties would be subject to a reasonable cause exception. In no event would the total amount of penalties exceed the gross reportable amount.

### **Effective date**

The reporting requirements and applicable penalties generally would apply to reportable events occurring or distributions received after the date of enactment. The annual reporting requirement and penalties applicable to U.S. grantors would apply to taxable years of such persons beginning after the date of enactment.

### **f. Reporting of certain foreign gifts**

The proposal generally would require any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources totaling more than \$10,000 during the taxable year to report them to the IRS. The definition of a gift to a U.S. person for this purpose would exclude qualified tuition or medical payments made on behalf of the U.S. person, as defined for gift tax purposes (sec. 2503(e)(2)). If the U.S. person fails, without reasonable cause, to report foreign gifts as required, the IRS would be authorized to determine, in its sole discretion, the tax treatment of the unreported gifts, based on information in its possession or as it may obtain. In addition, the U.S. person would be subject to a penalty equal to 5 percent of the amount of the gift for each month that the failure continues, with the total penalty not to exceed 25 percent of such amount.

### **Effective date**

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

## **17. Repeal 50-percent interest income exclusion for financial institution loans to ESOPs**

### **Present Law**

An employee stock ownership plan ("ESOP") is a qualified pension plan that meets certain requirements and under which employer securities are held for the benefit of employees. Present law generally prohibits loans between a qualified plan and a disqualified person. An exception to this rule is provided in the case of an ESOP.

If employer securities are acquired by an ESOP with loan proceeds, the ESOP is referred to as a leveraged ESOP. The ESOP may borrow directly from a financial institution (typically with a guarantee from the employer), or the employer may borrow from a financial institution and in turn lend the funds to the ESOP which then uses them to acquire employer securities. Such

loans are referred to as securities acquisition loans. The employer securities are typically pledged as security for the loan. The employer makes contributions to the ESOP which are then used to repay the securities acquisition loan. Shares that are purchased with a securities acquisition loan are allocated to the accounts of ESOP participants as the loan is repaid.

A bank, insurance company, regulated investment company, or a corporation actively engaged in the business of lending money may generally exclude from gross income 50 percent of interest received on an ESOP loan. The partial exclusion applies if the loan is made directly to the ESOP or if the loan is made to the employer who in turn lends the proceeds to the ESOP and certain requirements are satisfied. Generally effective for ESOP loans made after June 10, 1989, the 50-percent interest exclusion only applies if: (1) immediately after the acquisition of securities with the loan proceeds, the ESOP owns more 50 percent of the outstanding stock or more than 50 percent of the total value of all outstanding stock of the corporation; (2) the ESOP loan term will not exceed 15 years; and (3) the ESOP provides for full pass-through voting to participants on all allocated shares.

### **Description of Proposal**

The proposal would repeal the 50-percent interest exclusion with respect to ESOP loans.

### **Effective Date**

The proposal generally would be effective with respect to loans made after October 13, 1995. The repeal of the 50-percent interest exclusion would not apply to the refinancing of an ESOP loan originally made on or before October 13, 1995, provided (1) such refinancing loan otherwise meets the requirements of section 133 in effect before October 14, 1995; (2) the outstanding principal amount of the loan is not increased; and (3) the term of the refinancing loan does not extend beyond the term of the original ESOP loan.

## **18. Repeal the wine and flavors credit**

### **Present Law**

Distilled spirits are subject to excise tax at \$13.50 per proof gallon. (A proof gallon is a liquid gallon containing 50 percent alcohol). Wine is subject to a graduated excise tax based on alcohol content. All wine tax rates (other than on champagne) are lower on an alcohol content basis than the distilled spirits tax rate.

Present law allows an excise tax credit equal to the difference between the distilled spirits tax rate and the applicable wine tax rate when wine alcohol is blended into distilled spirits. Wine is defined as any alcohol derived from fruit. Wine alcohol is not required to be alcohol that could be marketed to the public for consumption as "wine".

Present law also allows an excise tax credit equal to \$13.50 per proof gallon (less an administrative processing fee) for each gallon of flavors contained in distilled spirits. Examples of "flavors" for which the credit is allowed are vanilla extract and mint. This credit is limited to tax on alcohol not exceeding 2.5 percent of the alcohol content of the finished product.

### **Description of Proposal**

The excise tax credits for wine alcohol and flavors content would be repealed.

### **Effective Date**

The proposal would be effective for distilled spirits removed from bonded premises after December 31, 1995.

## **19. Treatment of financial asset securitization investment trusts ("FASITs")**

### **Background and Present Law**

An individual can own income-producing assets directly, or indirectly through an entity (i.e., corporation, partnership, or trust). Where an individual owns assets through an entity (e.g., a corporation), the nature of the interest in the entity (e.g., stock of a corporation) is different than the nature of the assets held by the entity (e.g., assets of the corporation).

Securitization is the process of converting one type of asset into another and generally involves use of an entity separate from the underlying assets. In the case of securitization of debt instruments, the instruments created in the securitization typically have different maturities and characteristics than the debt obligations that are securitized.

Entities used in securitization include entities that are subject to tax (e.g., corporation), conduit entities that generally are not subject to tax (e.g., a partnership, grantor trust, or real estate mortgage investment conduit ("REMIC")), or partial-conduit entities that generally are subject to tax only to the extent its income is not distributed to its owners (e.g., a trust, real estate investment trust ("REIT"), or regulated investment company ("RIC")).

There is no statutory entity that facilitates the securitization of revolving, non-mortgage debt obligations.

### **Description of Proposal**

#### **In general**

The proposal would create a new type of statutory entity called a financial asset securitization investment trust ("FASIT") that would facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally



would not be taxable; the FASIT's taxable income or net loss would flow through to the owner of the FASIT.

The ownership of a FASIT generally would be required to be entirely by a single domestic C corporation. In addition, a FASIT generally could hold only cash, qualified debt obligations, certain other specified assets and would be subject to certain restrictions on its activities. An entity that qualifies as a FASIT could issue debt instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Debt instruments bearing yields to maturity over 5 percentage points above the yield to maturity on specified United States government obligations (i.e., a "high-yield debt obligation") could be held only by domestic C corporations and certain other specified entities.

To qualify as a FASIT, an entity would be subject to certain requirements, including: (1) an election must be made to be treated as a FASIT; (2) substantially all of its assets must be limited to certain specified assets; (3) the interests in the entity must be limited to an ownership interest or qualified debt instruments (including high-yield debt instruments); and (4) ownership of the ownership interest must be held by a domestic C corporation.

#### **Debt instruments issued by FASITs**

The proposal would allow FASITs to issue "regular" debt instruments, including "high-yield interest" instruments, that would be treated as debt for Federal tax purposes. Ownership of high-yield interest instruments would be limited to certain qualified holders (generally domestic C corporations).

#### **Transfers to non-permitted holders of certain FASIT interests**

A transfer of an ownership interest or a high-yield interest instrument to a disqualified holder, or a transfer of less than 100 percent of the interest interest to a transferee, would be ignored. Thus, such a transferor would continue to be liable for any taxes due on the transferred interest. Subject to certain exceptions, a disqualified holder generally is any holder other than a domestic C corporation.

#### **Taxation of a FASIT and interests in the FASIT**

A FASIT generally would not be subject to tax. However, a FASIT would be subject to tax at the highest corporate rate on income from any foreclosure property. In addition, a FASIT would be required to pay a tax equal to 100 percent of net income from certain types of income from entities not related to the FASIT's purposes. Income from dispositions that are exempt from the 100-percent tax include dispositions occurring in a qualified liquidation or any disposition incident to the foreclosure, default, or imminent default of the asset, or to the bankruptcy or insolvency of the FASIT.

The taxable income of a FASIT generally would be calculated as if it were a partnership using the accrual method of accounting. A holder of regular or high-yield debt instruments generally would be taxed in the same manner as a holder of any other debt instrument. However, qualified holders of high-yield debt would not be allowed to use net operating losses to offset any income derived from the high-yield debt. The holder of FASIT ownership interest would take into account the FASIT's taxable income or net loss for the taxable year. The character, source, and other attributes of the income to the holder of an ownership interest would be determined as if the income had been earned by a partnership.

A portion of any net loss of a FASIT could be taken into account by its owner to the extent of its adjusted basis in the ownership interest. Disallowed losses would be carried forward by the owner. A special rule provides that a FASIT owner cannot offset income from the FASIT by any other losses.

### **Transfers to and distributions from FASITs**

Gain or loss generally would be recognized immediately by the owner of the FASIT on the transfer of assets to a FASIT. However, to the extent provided by Treasury regulations, gain recognition on the contributed assets could be deferred until the FASIT securitizes its assets. For these purposes, the value of contributed assets generally would be the present value of the reasonably expected cash flows from such assets discounted over the weighted average life of such assets. The discount rate would be 130 percent of the applicable Federal rate for obligations with a maturity comparable to the average expected maturity of the pool of contributed debt instruments of the similar type.

A distribution of assets by a FASIT with respect to a debt instrument generally would be treated as a sale of the assets and a distribution of the sale proceeds. A distribution by a FASIT with respect to an ownership interest generally would not be included in gross income by the holder to the extent that the distribution does not exceed the adjusted basis of the holder's interest.

### **Effective Date**

The proposal would be effective on the date of enactment.

## **20. Treatment of contributions in aid of construction for water utilities**

### **Present and Prior Law**

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

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

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

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

### **Description of Proposal**

The proposal would restore the contributions in aid of construction provisions that were repealed by the 1986 Act for regulated public utilities that provide water or sewerage disposal services.

### **Effective Date**

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

## **21. Require water utility property to be depreciated over 25 years**

### **Present Law**

Property used by a water utility in the gathering, treatment, and commercial distribution of water and municipal sewers are depreciated over a 20-year period for regular tax purposes. The depreciation method generally applicable to property with a recovery period of 20 years is the 150-percent declining balance method (switching to the straight-line method in the year that maximizes the depreciation deduction). The straight-line method applies to property with a recovery period over 20 years.

### **Description of Proposal**

The proposal would provide that water utility property would have a recovery period of 25 years and would be depreciated under the straight-line method. For this purpose, "water utility property" would mean (1) property that is an integral part of the gathering, treatment, or commercial distribution of water, and that, without regard to the proposal, would have had a recovery period of 20 years and (2) any municipal sewer.

### **Effective Date**

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

## **22. Modifications to the excise tax on ozone-depleting chemicals**

### **Present Law**

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (Code sec. 4681). The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount is \$5.35 per pound in 1995 and will increase by 45 cents per pound per year thereafter.

Taxable chemicals that are recovered and recycled within the United States are exempt from tax.

### **Description of Proposal**

The proposal would extend the exemption from tax for domestically recovered recycled ozone-depleting chemicals to imported recycled halons.

### **Effective Date**

The proposal would be effective on the date of enactment.

## **23. Allow certain utilities to elect not to be eligible for future tax-exempt bond financing**

### **Present Law**

Interest on State and local government bonds generally is excluded from income unless the bonds are issued to provide financing for private parties. Present law includes several exceptions, however, that allow tax-exempt bonds to be used to provide for financing of certain specifically identified private parties. One such exception allows tax-exempt bonds to be issued for the

benefit of electric and gas utilities whose service area does not exceed (1) two contiguous counties or (2) a city and a contiguous county (i.e., "local furnishers").

Tax-exempt bonds issued for local furnishers of electricity and gas are subject to the general State private activity bond volume limits of the greater of \$50 per resident of the State or \$150 million per year. Like most other private beneficiaries of tax-exempt bonds, these local furnishers are denied interest deductions on debt underlying the bonds if they cease to qualify as a local furnisher. Additionally, as with all tax-exempt bonds, if the use of the proceeds (or the beneficiary of the bonds) changes its character to a use not qualified for tax-exempt financing within certain periods after the debt is incurred, interest on the bonds becomes taxable unless certain safe harbor standards are satisfied.

### **Description of Proposal**

The proposal would allow utilities that currently qualify as local furnishers of electricity or gas to elect to terminate that status and expand their service areas without incurring the present-law loss of interest deductions and loss of tax-exemption penalties if :

- (1) no additional bonds were issued for the benefit of the electing utility after the date of the proposal's enactment;
- (2) the expansion of the utility's service area was not financed with any tax-exempt bond proceeds; and
- (3) all outstanding tax-exempt bonds of the utility were redeemed not later than 6 months after the earliest date on which redemption is not prohibited (or 6 months after the election, if earlier).

The proposal further would limit the exception allowing tax-exempt bonds to be issued for local furnishers of electricity or gas to utilities that were qualified as such before the date of its enactment.

### **Effective Date**

The proposal would be effective on the date of enactment.

## **24. Tax-exempt bonds for the sale of Alaska Power Administration facility**

### **Present Law**

Interest on State and local government bonds generally is excluded from income unless the bonds are issued to provide financing for private parties. Present law includes several exceptions, however, that allow tax-exempt bonds to be used to provide financing for certain specifically identified private parties ("private activity bonds"). State and local government bonds issued to

acquire existing output property (other than water facilities) are treated as private activity bonds even if a State or local government owns or operates the property. Similarly, bonds issued to acquire existing property, the output from which will be sold to a private party under a take or pay contract are private activity bonds.

Most private activity bonds are subject to annual State volume limits of the greater of \$50 per resident of the State or \$150 million. Additionally, persons acquiring property financed with most private activity bonds must satisfy a rehabilitation requirement as a condition of the financing.

### **Description of Proposal**

The proposal would provide an exception from the general rehabilitation requirement for private activity bonds used to acquire existing property for certain bonds to finance the acquisition of the Snettisham hydroelectric project from the Alaska Power Administration. Bonds for this acquisition would remain subject to the State of Alaska's private activity bond volume limit.

### **Effective Date**

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

## **25. Treatment of certain gains and losses of life insurance companies under section 818(b)**

### **Present Law**

In the case of a taxpayer that is a corporation, losses from the sale or exchange of a capital asset generally are allowed only to the extent of gains from such sales or exchanges. A loss on the sale or exchange of property used in the trade or business of the taxpayer, however, may be treated as an ordinary loss, rather than as a loss from the sale or exchange of a capital asset.

A special limitation on ordinary loss treatment applies in the case of a life insurance company, under section 818(b). Section 818(b) provides that property used in the trade or business includes only property used in carrying on an insurance business. Thus, for example, a loss on the sale or exchange of real estate that is held by a life insurance company and that is not used in the insurance business is treated as a capital loss, and is allowed only to the extent of the taxpayer's capital gain.

### **Description of Proposal**

Under the proposal, capital loss treatment under present-law section 818(b) would not apply to 85 percent of a life insurance company's losses from dispositions of foreclosed real estate, and such losses would be allowed as ordinary losses in equal amounts over each of the first 10 taxable years following the year of disposition. Present-law section 818(b) treatment would be retained for the percentage of such losses that are not eligible for the treatment provided by the proposal.

### Effective Date

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

## **26. Coal industry retiree health equity**

### Present Law

The financing of retiree health benefits previously provided by the United Mine Workers of America ("UMWA") 1950 and 1974 Benefit Funds was substantially revised by the Energy Policy Act of 1992 (H.R. 776, P.L. 104-486), enacted October 2, 1992. The relevant provisions, contained in the Coal Industry Retiree Health Benefit Act of 1992 (the "Coal Act"), created two new UMWA retiree health benefit funds and completely changed the financing mechanism. The two funds, known as the UMWA Combined Benefit Fund and the UMWA 1992 Benefit Plan, service beneficiaries who retired on or before September 30, 1994. No provision was made for employees who retired or will retire after September 30, 1994. Future retirees will remain dependent on the provisions of future collective bargaining agreements.

Under the Coal Act, which supersedes the retiree health benefits financing provisions of the 1988 National Bituminous Coal Wage Agreement ("NBCWA"), a company is charged an insurance premium based on the number of beneficiaries assigned to the company in its role as the retiree's "last signatory employer." Under what are referred to as the "super-reachback" provisions of the Coal Act, companies responsible for paying premiums include any company that had signed any NBCWA since 1946 or any related company as defined under the Act. To cover the costs associated with beneficiaries who cannot be assigned, up to \$70 million per year is transferred into the Combined Fund. The first three transfers came from the surplus in the UMWA 1950 Pension Fund. Subsequent transfers will be made from the interest earnings of the Federal Abandoned Mine Reclamation Fund. If costs for unassigned beneficiaries exceed the annual transfer, they can be allocated to the signatory and reachback companies in proportion to their share of assigned beneficiaries.

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

### Description of Proposal

The proposal would provide relief to reachback companies by reducing their insurance premiums required to be paid to the Combined Fund for the period beginning October 1, 1995 through September 30, 1997, to the extent of any surplus in the Combined Fund. Under the proposal, the determination of whether the Combined Fund has any surplus would be made by the trustees at the end of each fund year on a cash basis. The amount of any surplus would be

reduced by an amount equal to 10 percent of the benefits and administrative costs paid by the Combined Fund for the plan year and would be determined without regard to amounts transferred to the Combined Fund from the UMWA 1950 Pension Fund and Federal Abandoned Mine Reclamation Fund. Any remaining surplus would be used to provide insurance premium relief to the reachback companies.

The proposal would also fix the actual per capita net expenses of the 1950 and 1974 Benefit Funds in fiscal year 1992 at \$2,116.67 per beneficiary.

### **Effective Date**

The proposal would apply to Combined Fund years beginning after September 30, 1995.

## **27. Treatment of newspaper distributors and carriers as direct sellers**

### **Present Law**

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

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

In addition to the 20-factor common-law test, there are also some persons who are treated by statute as either employees or independent contractors. For example, "direct sellers" are deemed to be independent contractors. A direct seller is a person engaged in the trade or business of selling consumer products in the home or otherwise than in a permanent retail establishment, if substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person



are performed pursuant to a written contract between such person and the service recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes.

The newspaper industry has generally taken the position that newspaper distributors and carriers should be treated as direct sellers for income and employment tax purposes. The Internal Revenue Service has generally taken the position that the direct seller rules do not apply to newspaper distributors and carriers operating under an agency distribution system (i.e., where the publisher retains title to the newspapers).

### **Description of Proposal**

The proposal would treat qualifying newspaper distributors and carriers as direct sellers. Under the proposal, a person engaged in the trade or business of the delivery or distribution of newspapers or shopping news (including any services that are directly related to such trade or business such as solicitation of customers or collection of receipts) would qualify as a direct seller, provided substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person are performed pursuant to a written contract between such person and the service recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes. For example, newspaper distributors and carriers operating under an agency distribution system who are paid based on the number of papers delivered and have an appropriate written agreement would be treated as direct sellers. The status of newspaper distributors and carriers who do not qualify as direct sellers under the proposal would continue to be determined under present-law rules. No inference is intended with respect to the employment status of the affected workers under present law.

### **Effective Date**

The proposal would be effective with respect to services performed after December 31, 1995.

**ERRATA FOR JCX-44-95**

- 1. On page 20-22 the description of SIMPLE retirement plans should be modified as follows:** on page 20, the second full paragraph should be deleted; on page 21, in the last paragraph beginning on the page, the sentence beginning "In addition," should be deleted; and on page 22, the last paragraph before the heading "Effective Date" should be deleted.
- 2. On page 31, delete the last sentence and insert the following:** "If stock in more than one RIC is received in a conversion, the basis of each RIC shall be determined by allocating the basis of common fund interests used in the exchange among each RIC received in the conversion on the basis of respective fair market values."
- 3. On page 62, the effective date should read as follows:** "The proposal would be effective for cash rentals after December 31, 1995."
- 4. On pages 113-115, the description of the proposed exemption from the UBIT for corporate sponsorship payments received by tax-exempt organizations should read as follows:**

**"Description of Proposal"**

Under the proposal, qualified sponsorship payments received by a tax-exempt organization (or State college or university described in section 511(d)(2)(B)) would be exempt from the UBIT.

For purposes of the proposal, "qualified sponsorship payments" received by a tax-exempt organization would be defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the organization's activities. Such a use or acknowledgment would not include advertising of such person's products or services -- meaning qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services. Thus, for example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event conducted by the organization, such payment would not be subject to the UBIT. In contrast, if the organization

provides advertising of a sponsor's products, the payment made to the organization by the sponsor in order to receive such advertising would be subject to the UBIT (provided that the other, present-law requirements for UBIT liability are found to exist).

The proposal would specifically provide that a qualified sponsorship payment does not include any payment where the amount of such payment is contingent, by contract or otherwise, upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to an activity. However, the fact that a sponsorship payment is contingent upon an event actually taking place or being broadcast, in and of itself, would not cause the payment to fail to be a qualified sponsorship payment. Moreover, distribution of a sponsor's products by the sponsor or the tax-exempt organization to the general public at a sponsored event, whether for free or for remuneration, would be considered to be "use or acknowledgment" of the sponsor's product lines (as opposed to advertising), and thus would not affect the determination of whether a payment made by the sponsor is a qualified sponsorship payment.

The proposal would not apply to the sale of advertising or acknowledgements in tax-exempt organization periodicals. For this purpose, the term "periodical" includes regularly scheduled and printed material that is not related to and primarily distributed in connection with a specific sponsored event.

The proposal would specifically provide that, to the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of the payment will be treated as a separate payment. Thus, if a sponsorship payment made to a tax-exempt organization entitles the sponsor to both product advertising and use or acknowledgment of the sponsor's name or logo by the organization, then the UBIT would not apply to the amount of such payment that exceeds the fair market value of the product advertising provided to the sponsor.

The exemption provided by the proposal would be in addition to other present-law exceptions from the UBIT (e.g., the exceptions for activities substantially all the work for which is performed by volunteers and for activities not regularly carried on). No inference would be intended as to the tax treatment under present-law rules of sponsorship payments received by tax-exempt organizations prior to 1996.

#### Effective Date

The proposal would apply to qualified sponsorship payments received after 1995."

**5. On page 129, add at the end of the third full paragraph the following language:** "Similarly, utilization of this 4-year income-spreading rule would not cause interest paid or accrued prior to January 1, 2001, to be nondeductible solely by reason of causing the contract to be treated as a single premium contract (i.e., a contract in which substantially all of the premiums are paid within 4 years after the date of purchase). In addition, the lapse of a contract into extended term insurance as a result of the changes made by the proposal, during the period

that the 4-year income spreading rule applies, would not cause interest paid or accrued prior to January 1, 2001, to be nondeductible solely by reason of causing the contract to be treated as a single premium contract or by reason of failure to meet the 4-out-of-7 rule."

**6. On page 140, the second full paragraph should read as follows:** "The proposal would not apply to transfers in taxable years beginning after December 31, 2001."