DESCRIPTION OF CHAIRMAN'S MARK RELATING TO TECHNICAL CORRECTION PROVISIONS

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of revenue reconciliation provisions, beginning on June 11, 1997. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark for various technical corrections to previously enacted tax legislation, including the Small Business Job Protection Act of 1996 (P.L. 104-188), Health Insurance Portability and Accountability Act of 1996 (P.L.104-191), Taxpayer Bill of Rights 2 (P.L. 104-268), and other recent tax acts. Except as otherwise noted, these technical corrections are proposed to be effective as if included in the original provisions to which they relate. Proposed technical corrections that are clerical in nature are not described in this document.

Separate documents provide descriptions of revenue reconciliation and simplification provisions of the Chairman's mark.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Chairman's Mark Relating to Technical Correction Provisions (JCX-22-97), June 9, 1997.

I. TECHNICAL CORRECTIONS TO THE SMALL BUSINESS JOB PROTECTION ACT OF 1996[2]

A. Small Business-Related Provisions

1. Returns relating to purchases of fish

Present Law

Every person engaged in the trade or business of purchasing fish for resale must file an informational return reporting its purchases from any person that is engaged in the trade or business of catching fish which are in excess of $600 for any calendar year. Persons filing such an informational return relating to the purchase of fish must furnish a statement showing the name and address of the person filing the return, as well as the amount shown on the return, to each person whose name is required to be disclosed on the return.

Description of Proposal

Every person filing an informational return relating to the purchase of fish would be required to furnish a statement showing the name, address and phone number of the person filing the return, as well as the amount shown on the return, to each person whose name is required to be disclosed on the return.

2. Charitable remainder trusts not eligible to be electing small business trusts

Present Law

Under present law, an electing small business trust may be a shareholder in an S corporation. In order to qualify for this treatment, all beneficiaries of the electing small business trust generally must be individuals or estates eligible to be S corporation shareholders. An exempt trust may not qualify as an electing small business trust.

Description of Proposal

The technical correction would clarify that charitable remainder annuity trusts and charitable remainder unitrusts may not be electing small business trusts.

[2] Referred to herein as the "Small Business Act."

3. Clarify the effective date for post-termination transition period provision

Present Law

Distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distributions were made by an S corporation (e.g., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination period are generally treated as made by a C corporation (i.e., treated by shareholders as taxable dividends to the extent of earnings and profits).

The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

The Small Business Act expanded the post-termination period to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of "determination" was expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person. The Small Business Act provision was effective for taxable years beginning after December 31, 1996.

Description of Proposal

The technical correction would clarify that the effective date for the Small Business Act provision affecting the post-termination transition period is for determinations after December 31, 1996, not for determinations with respect to taxable years beginning after December 31, 1996. However, in no event would the post-termination transition period expanded by the Small Business Act end before the end of the 120-day period beginning after the date of enactment of this Act.

4. Treatment of qualified subchapter S subsidiaries

Present Law

Pursuant to a provision of the Small Business Act, an S corporation is allowed to own a qualified subchapter S subsidiary. The term "qualified subchapter S subsidiary" means a domestic corporation that (1) is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if 100 percent of the stock of the subsidiary were held by its S corporation parent and (2) which the parent elects to treat as a qualified subchapter S subsidiary. Under the election, for all purposes of the Code, the qualified subchapter S subsidiary is not treated as a separate corporation and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

The legislative history of the provision provides that if an election is made to treat an existing corporation as a qualified subchapter S subsidiary, the subsidiary will be deemed to have liquidated under sections 332 and 337 immediately before the election is effective.

Description of Proposal

The technical correction would provide that the Secretary of the Treasury may provide, by regulations, instances where the separate corporate existence of a qualified subchapter S subsidiary may be taken into account for purposes of the Code. Thus, if an S corporation owns 100 percent of the stock of a bank (as defined in sec. 581) and elects to treat the bank as a qualified subchapter S subsidiary, it is expected that Treasury regulations would treat the bank as a separate legal entity for purposes of those Code provisions that apply specifically to banks (e.g., sec. 582).

Treasury regulations also may provide exceptions to the general rule that the qualified subchapter S subsidiary election is treated as a deemed section 332 liquidation of the subsidiary in appropriate cases. In addition, if the effect of a qualified subchapter S subsidiary election is to invalidate an election to join in the filing of a consolidated return for a group of subsidiaries that formerly joined in such filing, Treasury regulations may provide guidance as to the consolidated return effects of the S election.

B. Pension Provisions

1. Salary reduction simplified employee pensions ("SARSEPS")

Present Law

SARSEPs were repealed for years beginning after December 31, 1996, unless the SARSEP was established before January 1, 1997. Consequently, an employer was not permitted to establish a SARSEP after December 31, 1996. SARSEPs established before January 1, 1997, may continue to receive contributions under the rules in effect prior to January 1, 1997.

Description of Proposal

The proposal would clarify that new employees of an employer hired after December 31, 1996, may participate in a SARSEP of an employer established before January 1, 1997.

2. SIMPLE retirement plans

a. Maximum dollar limitation for SIMPLE IRAs

Present Law

The Small Business Act created a simplified retirement plan for small business called the savings incentive match plan for employees ("SIMPLE") retirement plan. A SIMPLE plan can be either an individual retirement arrangement ("IRA") for each employee or part of a qualified cash or deferred arrangement ("a 401(k) plan"). A SIMPLE IRA permits employees to make elective contributions up to $6,000 per year to their IRA. The employer is required to satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation, unless the employer elects a lower percentage matching contribution (but not less than 1 percent of each employee's compensation). Alternatively, an employer is permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee. The employer contribution amounts are contributed to the employee's IRA. The maximum contribution limitation to an IRA is $2,000.

Description of Proposal

The proposal would provide that in the case of a SIMPLE IRA, the $2,000 maximum limitation applicable to IRAs would be increased to the limitations in effect for contributions made under a qualified salary reduction arrangement. This would include employee elective contributions and required employer contributions.

b. Notification requirement for SIMPLE IRAs

Present Law

The trustee of any SIMPLE IRA is required to provide the employer maintaining the arrangement a summary plan description containing basic information about the plan. At least once a year, the trustee is also required to furnish an account statement to each individual maintaining a SIMPLE account. In addition, the trustee is required to file an annual report with the Secretary. A trustee who fails to provide any of such reports or descriptions will be subject to a penalty of $50 per day until such failure is corrected, unless the failure is due to reasonable cause.

Description of Proposal

The proposal would provide that insurers offering annuities for SIMPLE IRAs have the same reporting requirements as SIMPLE IRA trustees.

c. Reporting requirements for SIMPLE IRAs

Present Law

A trustee of an individual retirement account and the issuer of an individual retirement annuity must furnish reports regarding the account or annuity to the individual for whom the account or annuity is maintained not later than January 31 of the calendar year following the year to which the reports relate. In the case of a SIMPLE IRA, such reports are to be furnished within 30 days after each calendar year.

Description of Proposal

The proposal would conform the time for providing reports for SIMPLE IRAs to that for IRA reports generally. Thus, the proposal would provide that the report required to be furnished to the individual under a SIMPLE IRA would be provided within 31 days after each calendar year.

d. Application of exclusive plan requirement for SIMPLE IRAs to noncollectively bargained employees

Present Law

A SIMPLE IRA will be treated as a qualified salary reduction arrangement provided the employer does not maintain a qualified plan during the same time period the SIMPLE IRA is maintained. Collectively bargained employees can be excluded from participation in the SIMPLE IRA and may be covered under a plan established by the employer as a result of a good faith bargaining agreement.

Description of Proposal

The proposal would provide that an employer who maintains a plan for collectively bargained employees is permitted to maintain a SIMPLE IRA for noncollectively bargained employees.

e. Application of exclusive plan requirement for SIMPLE IRAs in the case of mergers and acquisitions

Present Law

Only employers who employ 100 or fewer employees who received compensation for the preceding year of at least $5,000 are eligible to establish a SIMPLE IRA. An eligible employer maintaining a SIMPLE IRA who fails to be an eligible employer due to an acquisition, disposition or similar transaction will be treated as an eligible employer for the 2 years following the last year the employer was eligible provided rules similar to the special coverage rules of section 410(b)(6)(C)(I) apply. There is no parallel provision with respect to an employer who, because of an acquisition, disposition or similar transaction, maintains a qualified plan and a SIMPLE IRA at the same time.

Description of Proposal

The proposal would provide that if an employer maintains a qualified plan and a SIMPLE IRA in the same year due to an acquisition, disposition or similar transaction the SIMPLE IRA will be treated as a qualified salary reduction arrangement for the year of the transaction and the following calendar year.

f. Cost of living adjustments for SIMPLE 401(k) arrangements

Present Law

The $6,000 limit on deferrals to a SIMPLE IRA is subject to a cost-of-living adjustment. There is no parallel provision applicable to a SIMPLE 401(k) arrangement.

Description of Proposal

The proposal would provide that the $6,000 limit on elective deferrals under a SIMPLE 401(k) arrangement would be adjusted at the same time and in the same manner as for SIMPLE IRAs.

g. Top-heavy exemption for SIMPLE 401(k) arrangements

Present Law

A plan meeting the SIMPLE 401(k) requirements for any year is not treated as a top-heavy plan under section 416 for the year. This rule was intended to apply only to SIMPLE 401(k)s, and not other plans maintained by the employer.

Description of Proposal

The proposal would provide that the top-heavy exemption would apply to a plan which permits only contributions required to satisfy the SIMPLE 401(k) requirements.

h. Employer deduction for SIMPLE 401(k) arrangements

Present Law

Contributions paid by an employer to a profit sharing or stock bonus plan are deductible by the employer for a taxable year to the extent the contributions do not exceed 15-percent of the compensation otherwise paid or accrued during the taxable year to the participants under the plan. Contributions paid by an employer to a profit sharing or stock bonus plan that are not deductible because they are in excess of the 15-percent limitation are subject to a 10-percent excise tax payable by the employer making the contribution.

Description of Proposal

The proposal would provide that to the extent that contributions paid by an employer to a SIMPLE 401(k) arrangement satisfy the contribution requirements of section 401(k)(11)(B), such contributions will be deductible by the employer for the taxable year.

i. Notification and election periods for SIMPLE 401(k) arrangements

Present Law

An employer maintaining a SIMPLE 401(k) arrangement is required to make a matching contribution for employees making elective deferrals of up to 3-percent of compensation (or, alternatively, elect to make a 2-percent of compensation nonelective contribution on behalf of all eligible employees). An employer electing to make a 2-percent nonelective contribution is required to notify all employees of such election within a reasonable period of time before the 60th day before the beginning of the year.

An employer maintaining a SIMPLE IRA is required to notify each employee of the employee's opportunity to make or modify salary reduction contributions as well as the contribution alternative chosen by the employer within a reasonable period of time before the employee's election period. The employee's election period is the 60-day period before the beginning of any year (and the 60-day period before the first day such employee is eligible to participate).

Description of Proposal

The proposal would extend the employer notice and employee election requirements of SIMPLE IRAs to SIMPLE 401(k) arrangements.

Effective Date

The proposal would be effective with respect to calendar years beginning after the date of enactment.

C. Foreign Provisions

1. Measurement of earnings of controlled foreign corporations

Present Law

U.S. 10-percent shareholders of a controlled foreign corporation (CFC) are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in United States property. For this purpose, earnings include both current and accumulated earnings and profits.

Description of Proposal

The proposal would clarify that accumulated earnings and profits of a CFC taken into account for purposes of determining the CFC's earnings invested in United States property do not include current earnings (which are taken into account separately).

2. Transfers to foreign trusts at fair market value

Present Law

A U.S. person who transfers property to a foreign trust which has U.S. beneficiaries generally is treated as the owner of such trust. However, this rule does not apply in the case of a transfer to a trust in exchange for fair market value consideration. In determining whether fair market value consideration is received, obligations of certain related persons are not taken into account. For this purpose, related persons include any grantor or beneficiary of the trust and certain persons who are related to any such grantor or beneficiary.

Description of Proposal

The proposal would clarify that, for purposes of determining whether a U.S. person's transfer to a trust is for fair market value consideration, the related persons whose obligations are disregarded include any owner of the trust and certain persons who are related to any such owner.

3. Treatment of trust as United States person

Present Law

A trust is considered to be a United States person if two criteria are met. First, a court within the United States must be able to exercise primary supervision over the administration of the trust. Second, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust.

These criteria regarding the treatment of a trust as a United States person are effective for taxable years beginning after December 31, 1996. The Internal Revenue Service announced procedures under which a U.S. trust in existence on August 20, 1996 may continue to file returns as a U.S. trust for taxable years beginning after December 31, 1996. To qualify for such treatment, the trustee (1) must initiate modification of the trust to conform to the new criteria by the due date for filing the trust's return for its first taxable year beginning after 1996, (2) must complete the modification within two years of such date, and (3) must attach the required statement to the trust returns for the taxable years beginning after 1996.[3]

Description of Proposal

The proposal would clarify that a trust would be treated as a U.S. person as long as one or more U.S. persons have the authority to control all substantial decisions of the trust (and a U.S. court can exercise primary supervision). In addition, the proposal would clarify that a trust that is a foreign trust under these criteria would not be considered to be present or resident in the United States at any time. Finally, the proposal would provide the Secretary of Treasury with authority to allow reasonable time for U.S. trusts in existence on August 20, 1996 to make modifications in order to comply with the new criteria for treatment of a trust as a United States person.

[3] Notice 96-65, I.R.B. 1996-52. See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress (JCS-12-96), December 12, 1996, pp. 277-278.

D. Excise Tax Provisions

1. Phaseout and expiration of excise tax on luxury automobiles

The technical correction would clarify that the phased reduction in luxury excise tax rates and the expiration date of December 31, 2002, enacted as part of the Small Business Act, apply both for the tax imposed on the purchase of new automobiles under section 4001 and for the tax imposed for the separate purchase of vehicles and parts and accessories therefor under section 4003.

2. Repeal "deadwood" provisions relating to previous allowance of advance refunds of diesel fuel tax

Present Law

The Small Business Act repealed a provision allowing purchasers of diesel-powered automobiles and light trucks to claim a tax credit equal to an assumed amount of diesel fuel tax that they would pay over the life of the vehicle. Several accounting provisions in the Code's Highway Trust Fund rules that relate to this repealed provision were inadvertently retained.

Description of Proposal

The proposal would repeal the Highway Trust Fund provisions relating to the diesel fuel advance refunds, as "deadwood."

3. Clarify effective date of technical correction related to ethanol refunds

Present Law

Present law includes a 54-cents-per-gallon income tax credit for ethanol used as a motor fuel. This tax benefit may be claimed through reduced-rate gasoline sales or expedited refunds of gasoline tax paid when the ethanol is blended with gasoline. The Small Business Act corrected a previous technical error in the expiration date of the expedited refund provision, but the correction inadvertently failed to include refunds for periods before its enactment.

Description of Proposal

The proposal would clarify that the technical correction relating to the expedited ethanol refunds was retroactive to the provision's expiration after September 30, 1995. Claims for refunds of tax paid during the period October 1, 1995, through the date of enactment of the Small Business Act would have to be filed before 60 days after enactment of the proposal.

4. Clarify scope of aviation excise tax exemption for emergency medical aircraft

Present Law

The Small Business Act provided that fixed-wing aircraft that are equipped for and exclusively dedicated to the provision of emergency medical services (i.e., air ambulances) are exempt from the aviation excise taxes.

Description of Proposal

The proposal would clarify that this exemption is applied on a flight-by-flight basis.

E. Other Provisions

1. Treatment of certain reserves of thrift institutions

Present Law

A provision of the Small Business Act repealed the percentage-of-taxable income method for deducting bad debts applicable to thrift institutions. The portion of the section 481(a) adjustment applicable to pre-1988 reserves of an institution required to change its method of accounting generally is not restored to income unless the institution makes a distribution to which section 593(e) applies. Section 593(e) provides that if a institution makes a nonliquidating distribution in an amount in excess of its post-1951 accumulated earnings and profits, such excess will be treated as a distribution of the post-1987 reserve for bad debts, requiring recapture of such amount.

Another provision of the Small Business Act allows a bank or a thrift institution to elect to be treated as an S corporation so long as the entity does not use a reserve method of accounting for bad debts. The earnings of an S corporation increase the corporation's accumulated adjustments account, but do not increase its accumulated earnings and profits (sec. 1368). In addition, any net unrealized built-in gains of a C corporation that converts to S corporation status that are recognized during the 10-year period beginning with the date of such conversion generally are subject to corporate-level tax (sec. 1374). Section 481(a) adjustments taken into account during the 10-year period generally are subject to section 1374.

Description of Proposal

The proposal would provide rules to clarify the section 593(e) treatment of pre-1988 bad debt reserves of thrift and former thrift institutions that become S corporations. The proposed technical corrections would provide that (1) the accumulated adjustments account of an S corporation would be treated the same as post-1951 earnings and profits for purposes of section 593(e) and (2) section 593(e) would apply irrespective of section 1374 (e.g., distributions that trigger section 593(e) would be subject to corporate-level recapture even if such distributions occur after the 10-year period of section 1374).

2. "FASIT" technical corrections

Present Law

In general

A "financial asset securitization investment trust" ("FASIT") is designed to facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally is not taxable; the FASIT's taxable income or net loss flows through to the owner of the FASIT.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. In addition, a FASIT generally must hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue instruments (called "regular interests") that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. In general, those requirements must be met "after the startup date." Instruments bearing yields to maturity over 5 percentage points above the yield to maturity on specified United States government obligations (i.e., "high-yield interests") may be held only by domestic C corporations that are not exempt from income tax.

Income from prohibited transactions

The owner of a FASIT is required to pay a penalty excise tax equal to 100 percent of net income derived from (1) an asset that is not a permitted asset, (2) any disposition of an asset other than a permitted disposition, (3) any income attributable to loans originated by the FASIT, and (4) compensation for services (other than fees for a waiver, amendment, or consent under permitted assets not acquired through foreclosure). A permitted disposition is any disposition of any permitted asset (1) arising from complete liquidation of a class of regular interests (i.e., a qualified liquidation)[4]; (2) incident to the foreclosure, default, or imminent default of the asset; (3) incident to the bankruptcy or insolvency of the FASIT; (4) necessary to avoid a default on any indebtedness of the FASIT attributable to a default (or imminent default) on an asset of the FASIT; (5) to facilitate a clean-up call; (6) to substitute a permitted debt instrument for another such instrument; or (7) in order to reduce over-collateralization where a principal purpose of the disposition was not to avoid recognition of gain arising from an increase in its market value after its acquisition by the FASIT.

Definition of "FASIT"

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following "permitted assets": (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; (6) a regular interest in another FASIT; and (7) a regular interest in a REMIC. A FASIT must meet the asset test at the 90th day after its formation and at all times thereafter. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

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[4] For this purpose, a "qualified liquidation" has the same meaning as it does purposes of the exemption from the tax on prohibited transactions of a real estate mortgage investment conduit ("REMIC") in section 860F(a)(4).

Description of Proposal

Definition of regular interest

The provision would provide that the requirement of a "regular interest" must be met "on or after the startup date," instead of just "after the startup date."

Correction of cross reference

The provision would correct an incorrect cross reference in section 860L(d)from section 860L(c)(2) to section 860L(b)(2).

Tax on prohibited transactions

The provision would provide that the tax on prohibited transactions would not apply to dispositions of foreclosure property or hedges using the similar exception applicable to REMICs.

3. Qualified State tuition plans

Present Law

Section 529 provides tax-exempt status to certain qualified State tuition programs and provides rules for the tax treatment of distributions from such programs. Section 529 was effective on the date of enactment of the Small Business Act, but a special transition rule provides that if (1) a State maintains (on the date of enactment) a program under which persons may purchase tuition credits on behalf of, or make contributions for educational expenses of, a designated beneficiary, and (2) such program meets the requirements of a qualified State tuition program before the later of (a) one year after the date of enactment, or (b) the first day of the first calendar quarter after the close of the first regular session of the State legislature that begins after the date of enactment, then the provisions of the Small Business Act will apply to contributions (and earnings allocable thereto) made before the date the program meets the requirements of a qualified State tuition program, without regard to whether the requirements of a qualified State tuition program are satisfied with respect to such contributions and earnings (e.g., even if the interest in the tuition or educational savings program covers not only qualified higher education expenses but also room and board expenses).

Description of Proposal

The proposal would clarify that, if a State program under which persons may purchase tuition credits comes into compliance with the requirements of a "qualified State tuition program" as defined in section 529 within a specified time period, then such program would be treated as a qualified State tuition program with respect to any contributions (and earnings allocable thereto) made pursuant to a contract entered into under the program before the date on which the program comes into compliance with the present-law requirements of a qualified State tuition program under section 529.

4. Adoption tax credit

Present Law

Taxpayers are allowed a maximum nonrefundable tax credit against income tax liability of $5,000 per child for qualified adoption expenses ($6,000 in the case of certain domestic adoptions) paid or incurred by the taxpayer. Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are directly related to the legal adoption of an eligible child.

Otherwise qualified adoption expenses paid or incurred in one taxable year are not taken into account for purposes of the credit until the next taxable year unless the expenses are paid or incurred in the year the adoption becomes final.

Description of Proposal

The technical correction would conform the treatment of otherwise qualified adoption expenses paid or incurred in years after the year the adoption becomes final to the treatment of expenses paid or incurred in the year the adoption becomes final. Another technical correction would repeal as "deadwood" an ordering rule inadvertently included in the credit.

5. Phaseout of adoption assistance exclusion

Present Law

The adoption tax credit and the exclusion for employer provided adoption assistance are generally phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and are fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating 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).

Description of Proposal

The technical correction would conform the phaseout range of the adoption assistance exclusion to the phaseout range of the credit for qualified adoption expenses.

II. HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996

1. Medical savings accounts

a. Definition of permitted coverage

Present Law

Under present law, in order to be eligible to have a medical savings account ("MSA") an individual must be covered under a high deductible health plan and no other health plan, except for plans that provide certain permitted coverage. Medicare supplemental plans are one of the types of permitted coverage, even though an individual covered by Medicare is not eligible to have an MSA.

Description of Proposal

Under the proposal, Medicare supplemental plans would be deleted from the types of permitted coverage an individual may have and still qualify for an MSA.

b. Taxation of distributions

Present Law

Under present law, in order to be eligible to have a medical savings account ("MSA") an individual must be covered under a high deductible health plan and no other health plan, except for plans that provide certain permitted coverage and must be either (1) a self-employed individual, or (2) employed by a small employer. Distributions from an MSA for the medical expenses of the MSA account holder and his or her spouse or dependents are generally excludable from income. However, in any year for which a contribution is made to an MSA, withdrawals from the MSA are excludable from income only if the individual for whom the expenses were incurred was an eligible individual for the month in which the expenses were incurred. This rule is designed to ensure that MSAs are used in conjunction with a high deductible plan and that they are not primarily used by other individuals who have health plans that are not high deductible plans.

Description of Proposal

The proposal would clarify that, in any year for which a contribution is made to an MSA, withdrawals from the MSA are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible health plan (and no other health plan except for plans that provide certain permitted coverage) in the month in which the expenses were incurred. That is, the individual for whom the expenses were incurred does not have to be self employed or employed by a small employer in order for a withdrawal for medical expenses to be excludible.

2. Definition of chronically ill individual under a qualified long-term care insurance contract

Present Law

Under the long-term care insurance rules, a chronically ill individual is 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 for at least 90 days due to a loss of functional capacity, (2) having a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described above, or (3) requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. A contract is not treated as a qualified long-term care insurance contract unless the determination of whether an individual is a chronically ill individual takes into account at least 5 of such activities.

Description of Proposal

The technical correction would clarify that the five-activity requirement--i.e., that the number of activities of daily living that are taken into account not be less than five--applies only for purposes of the first of three alternative definitions of a chronically ill individual (Code sec. 7702B(c)(2)(A)(I)), that is, by reason of the individual being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days due to a loss of functional capacity. Thus, the requirement would not apply to the determination of whether an individual is a chronically ill individual either (1) by virtue of severe cognitive impairment, or (2) if the insured satisfies a standard (if any) that is not based upon activities of daily living, as determined under regulations.

3. Deduction for long-term care insurance of self-employed individuals

Present Law

Present law provides that the deduction for health insurance expenses of a self-employed individual is not available for a month for which the individual is eligible to participate in any subsidized health plan maintained by any employer of the individual or the individual's spouse. Present law also provides that in the case of a qualified long-term care insurance contract, only eligible long-term care premiums (as defined for purposes of the medical expense deduction) are taken into account in determining the deduction for health insurance expenses of a self-employed individual.

Description of Proposal

The technical correction would apply the rules for the deduction for health insurance expenses of a self-employed individual separately with respect to (1) plans that include coverage for qualified long-term care services or that are qualified long-term care insurance contracts, and (2) plans that do not include such coverage and are not such contracts. Thus, the provision would clarify that the fact that an individual is eligible for employer-subsidized health insurance does not affect the ability of such an individual to deduct long-term care insurance premiums, so long as the individual is not eligible for employer-subsidized long-term care insurance.

4. Applicability of reporting requirements of long-term care contracts and accelerated death benefits

Present Law

Present law provides that amounts (other than policyholder dividends or premium refunds) received under a long-term care insurance contract generally are excludable as amounts received for personal injuries and sickness, subject to a dollar cap on per diem contracts only. If the aggregate amount of periodic payments under all qualified long-term care contracts exceeds the dollar cap for the period, then the amount of such excess payments is excludable only to the extent of the individual's costs (that are not otherwise compensated for by insurance or otherwise) for long-term care services during the period.

Present law also provides 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 any portion of the death benefit under a life insurance contract to a qualified viatical settlement provider, provided that the insured under the life insurance contract is either terminally ill or chronically ill (the accelerated death benefit rules).

A payor of long-term care benefits (defined for this purpose to include any amount paid under a product advertised, marketed or offered as long-term care insurance), and a payor of amounts treated as subject to reporting under the accelerated death benefit rules, is required to report to the IRS the aggregate amount of such benefits paid to any individual during any calendar year, and the name, address and taxpayer identification number of such individual. A payor is also required to report the name, address, and taxpayer identification number of the chronically ill individual on account of whose condition the amounts are paid, and whether the contract under which the amount is paid is a per diem-type contract. A copy of the report must be provided to the payee by January 31 following the year of payment, showing the name of the payor and the aggregate amount of benefits paid to the individual during the calendar year. Failure to file the report or provide the copy to the payee is subject to the generally applicable penalties for failure to file similar information reports.

Description of Proposal

The technical correction would clarify that the reporting requirements include the need to report the address and phone number of the information contact. This conforms these reporting requirements to the requirements of the Taxpayer Bill of Rights 2.

5. Consumer protection provisions for long-term care insurance contracts

Present Law

The long-term care insurance rules of present law include consumer protection provisions (sec. 7702B(g)). Among these provisions is a requirement that the issuer of a contract offer to the policyholder a nonforfeiture provision that meets certain requirements. The requirements include a rule that the nonforfeiture provision shall provide for a benefit available in the event of a default in the payment of any premiums and the amount of the benefit may be adjusted subsequent to being initially granted only as necessary to reflect changes in claims, persistency, and interest as reflected in changes in rates for premium paying policies approved by the Secretary for the same contract form.

Description of Proposal

The technical correction would clarify that the nonforfeiture provision shall provide for a benefit available in the event of a default in the payment of any premiums and the amount of the benefit may be adjusted subsequent to being initially granted only as necessary to reflect changes in claims, persistency, and interest as reflected in changes in rates for premium paying policies approved by the appropriate State regulatory authority (not by the Secretary) for the same contract form.

6. Insurable interests under the COLI provision

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer (the COLI rule). An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

Description of Proposal

The technical correction would prevent unintended avoidance of the COLI rule by clarifying that the rule relates to life insurance policies or annuity or endowment contracts covering any individual who (1) is or was an officer or employee of, or (2) is or was financially interested in, any trade or business carried on currently or formerly by the taxpayer. Thus, for example, the provision would clarify the treatment of interest on debt with respect to contracts covering former employees of the taxpayer. As another example, the provision would clarify the treatment of interest on debt with respect to a business formerly conducted by the taxpayer and transferred to an affiliate of the taxpayer.

7. Applicable period for purposes of applying the interest rate for a variable rate contract under the COLI rules

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

This provision generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986. If the policy loan interest rate under such a contract does not provide for a fixed rate of interest, then interest on such a contract paid or accrued after December 31, 1995, is allowable only to the extent the rate of interest for each fixed period selected by the taxpayer does not exceed Moody's Corporate Bond Yield Average--Monthly Average Corporates, for the third month preceding the first month of the fixed period. The fixed period must be 12 months or less.

Description of Proposal

The technical correction would provide that an election of an applicable period for purposes of applying the interest rate for a variable rate contract can be made no later than the 90th date after the date of enactment of the proposal, and would apply to the taxpayer's first taxable year ending on or after October 13, 1995. If no election is made, the applicable period would be the calendar year.

8. Definition of 20-percent owner for purposes of key person exception under COLI rule

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) 5 individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 20 individuals. Employees are to be full-time employees, for this purpose. A 20-percent owner is an individual who directly owns 20 percent or more of the total combined voting power of the corporation. If the taxpayer is not a corporation, the statute states that a 20-percent owner is an individual who directly owns 20 percent or more of the capital or profits interest of the employer.

Description of Proposal

The technical correction would clarify that, in determining a key person, if the taxpayer is not a corporation, a 20-percent owner is an individual who directly owns 20 percent or more of the capital or profits interest of the taxpayer.

9. Effective date of interest rate cap on key persons and pre-1986 contracts under the COLI rule

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

This provision generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986. If the policy loan interest rate under such a contract does not provide for a fixed rate of interest, then interest on such a contract paid or accrued after December 31, 1995, is allowable only to the extent the rate of interest for each fixed period selected by the taxpayer does not exceed Moody's Corporate Bond Yield Average--Monthly Average Corporates, for the third month preceding the first month of the fixed period. The fixed period must be 12 months or less.

The interest rate cap on key persons and pre-1986 contracts is effective with respect to interest paid or accrued for any month beginning after December 31, 1995. Another part of the provision provides that the interest rate cap on key employees and pre-1986 contracts applies to interest paid or accrued after October 13, 1995.

Description of Proposal

The technical correction would clarify that, under the COLI rule, the interest rate cap on key persons and pre-1986 contracts applies to interest paid or accrued for any month beginning after December 31, 1995. This would conform conflicts in the effective date provisions.

10. Clarification of contract lapses under effective date provisions of the COLI rule

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

Additional limitations are imposed on the deductibility of interest with respect to single premium contracts, and interest 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. 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).

Present law provides that the COLI rule is phased in. In connection with the phase-in rule, a transition rule provides that any amount included in income during 1996, 1997, or 1998, that is received under a contract described in the provision 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, is includable ratably over the first 4 taxable years beginning with the taxable year the amount would otherwise have been includable. The lapse of a contract after October 13, 1995, due to nonpayment of premiums does not cause interest paid or accrued prior to January 1, 1999, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule of present law, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1). This lapse provision states that the relief is provided in the following case: solely by reason of no additional premiums being received by reason of a lapse.

Description of Proposal

The technical correction would clarify that, under the transition relief provided under the COLI rule, the 4-out-of-7 rule and the single premium rule of present law are not to apply solely by reason of a lapse occurring by reason of no additional premiums being received under the contract after October 13, 1995.

11. Requirement of gain recognition on certain exchanges

Present Law

Under the expatriation tax provisions in section 877, special tax treatment applies to certain former U.S. citizens and former U.S. long-term residents for 10 years following the date of loss of U.S. citizenship or residency status. Gain recognition is required on certain exchanges of property following loss of U.S. citizenship or U.S. residency status, unless a gain recognition agreement is entered into. In addition, regulatory authority is granted to apply this rule to the 15-year period beginning 5 years before the loss of U.S. citizenship or U.S. residency status.

Description of Proposal

The proposal would clarify that the period to which the general rule requiring gain recognition on certain exchanges applies is the 10-year period that begins on the date of loss of United States citizenship. In addition, the proposal would clarify that in the case of an exchange occurring during the 5-year period before the loss of U.S. citizenship, any gain required to be recognized under regulations would be recognized immediately after the date of such loss of citizenship.

12. Suspension of 10-year period in case of substantial diminution of risk of loss

Present Law

Under the expatriation tax provisions in section 877, special tax treatment applies to certain former U.S. citizens and former U.S. long-term residents for 10 years following the date of loss of U.S. citizenship or residency status. The running of this period with respect to gain on the sale or exchange of any property is suspended for any period during which the individual's risk of loss with respect to the property is substantially diminished.

Description of Proposal

The proposal would clarify that the period to which the rule suspending such period in the case of a substantial diminution of risk of loss applies is the 10-year period that begins on the date of loss of United States citizenship or U.S. residency status.

13. Treatment of property contributed to certain foreign corporations

Present Law

Under the expatriation tax provisions in section 877, special tax treatment applies to certain former U.S. citizens and former U.S. long-term residents for 10 years following the date of loss of U.S. citizenship or residency status. Special rules apply in the case of certain contributions of U.S. property by such an individual to a foreign corporation during such period.

Description of Proposal

The proposal would clarify that the period to which the rule regarding certain contributions to foreign corporations applies is the 10-year period that begins on the date of loss of United States citizenship or U.S. residency status. The proposal also would clarify that the rule applies in the case of property the income from which, immediately before the contribution, was from U.S. sources.

14. Credit for foreign estate tax

Present Law

Under the expatriation tax provisions in section 2107, special estate tax treatment applies to certain former U.S. citizens and former U.S. long-term residents who die within 10 years following the date of loss of U.S. citizenship or residency status. Special rules provide a credit against the U.S. estate tax for foreign estate taxes paid with respect to property that is includible in the decedent's U.S. estate solely by reason of the expatriation estate tax provisions.

Description of Proposal

The proposal would clarify the formula for determining the amount of credit allowable against U.S. estate taxes on such property.

III. TECHNICAL CORRECTIONS TO THE TAXPAYER BILL OF RIGHTS 2

1. Reasonable cause abatement for first-tier intermediate sanctions excise tax

Present Law

Section 4958 imposes penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under sections 501(c)(3) or 501(c)(4) (other than private foundations) engage in an "excess benefit transaction." The excise tax may be imposed on certain disqualified persons (i.e., insiders) who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper.

A disqualified person who benefits from an excess benefit transaction is subject to a first-tier penalty tax equal to 25 percent of the amount of the excess benefit. Organization managers who participate in an excess benefit transaction knowing that it is improper are subject to a first-tier penalty tax of 10 percent of the amount of the excess benefit. Additional second-tier taxes equal to 200 percent of the amount of the excess benefit may be imposed on a disqualified person if there is no correction of the transaction within a specified time period.

Under section 4962, the IRS has the authority to abate certain first-tier taxes if the taxable event was due to reasonable cause and not to willful neglect and the event was corrected within the applicable correction period. First-tier taxes which may be abated include, among others, the taxes imposed under sections 4941 (on acts of self-dealing between private foundations and disqualified persons), 4942 (for failure by private foundations to distribute a minimum amount of income), and 4943 (on private foundations with excess business holdings).

In enacting the new excise taxes on excess benefit transactions, Congress explicitly intended to provide the IRS with abatement authority under section 4962.[5] However, the abatement rules of section 4962 apply only to qualified first-tier taxes imposed by subchapter A or C of Chapter 42. The section 4958 excise tax is located in subchapter D of Chapter 42. The failure to cross reference subchapter D in section 4962 means that IRS does not have such abatement authority with respect to the section 4958 excise taxes.

Description of Proposal

The proposal would amend section 4962(b) to include a cross-reference to first-tier taxes imposed by subchapter D (i.e., the section 4958 excise taxes on excess benefit transactions). Thus, the IRS would have authority to abate the first-tier excise taxes on excess benefit transactions in cases where it is established that the violation was due to reasonable cause and not due to willful neglect and the transaction at issue was corrected within the specified period.

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[5] See Ways and Means Committee Report 104-506 accompanying H.R. 2377, p. 59.

2. Reporting by public charities with respect to intermediate sanctions and certain other excise tax penalties

Present Law

Section 4958 imposes penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under sections 501(c)(3) or 501(c)(4) (other than private foundations) engage in an "excess benefit transaction." The excise tax may be imposed on certain disqualified persons (i.e., insiders) who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper. No tax is imposed on the organization itself with respect under section 4958.

Section 4911 imposes an excise tax penalty on excess lobbying expenditures made by public charities. The tax is imposed on the organization itself. Section 4912 imposes a penalty excise tax on certain public charities that make disqualifying lobbying expenditures and section 4955 imposes a penalty excise tax on political expenditures of section 501(c)(3) organizations. Both of these penalty taxes are imposed not only on the affected organization, but also on organization managers who agree to an expenditure knowing that it is improper.

Under section 4962, the IRS has the authority to abate certain first-tier taxes if the taxable event was due to reasonable cause and not to willful neglect and the event was corrected within the applicable correction period. First-tier taxes which may be abated include, among others, the taxes imposed under section 4955.[6]

Under section 6033(b)(10), 501(c)(3) organizations are required to report annually on Form 990 any amounts paid by the organization under section 4911, 4912, and 4955. Thus, although sections 4912 and 4955 impose excise taxes on organization managers, organizations technically are not required to report any such excise taxes paid by such managers.

In addition, under section 6033(b)(11), an organization exempt from tax under section 501(c)(3) must report on Form 990 any amount of excise tax on excess benefit transactions paid by the organization, or any disqualified person with respect to such organization, during the taxable year. The Code does not explicitly require the reporting of any excess benefit excise taxes paid by an organization manager solely in his or her capacity as such (i.e., an organization manager might also be a disqualified person with respect to an excess benefit transaction, in which case any tax paid would be reported).

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[6] A separate provision (III.1., above) would make a technical correction to section 4962(b) to permit the abatement of first-tier penalty excise taxes imposed under section 4958.

Description of Proposal

The proposal would make the reporting requirements of section 6033(b)(10) and (11) consistent with the excise tax penalty provisions to which they relate. Thus, section 6033(b)(10) would be amended to require 501(c)(3) organizations to report any amounts of tax imposed under sections 4911, 4912, and 4955 on the organization or any organization manager of the organization. In addition, the proposal would require reporting with respect to any reimbursements paid by an organization with respect to taxes imposed under sections 4912 or 4955 on any organization manager of the organization. Section 6033(b)(11) would be amended to require 501(c)(3) organizations to report any amounts of tax imposed under section 4958 on any organization manager or any disqualified person, as well as any reimbursements of section 4958 excise tax liability paid by the organization to such organization managers or disqualified persons.

In addition, the proposal would clarify that no reporting is required under sections 6033(b)(10) or (11) in the event a first-tier penalty excise tax imposed under section 4955 or section 4958 is abated by the IRS pursuant to its authority under section 4962.

IV. TECHNICAL CORRECTIONS TO OTHER ACTS

1. Related parties determined by reference to section 267

Present Law

Section 267 disallows loses arising in transactions between certain defined related parties. In the case of related corporations, such losses may be deferred. Several Code provisions, in defining related parties, often incorporate the relationships described in section 267 by cross-reference to such section.

Description of Proposal

Any provision of the Internal Revenue Code of 1986 that refers to a relationship that would result in loss disallowance under section 267 also refers to relationships where loss is deferred, where such relationship is applicable to the provision.

Effective Date

The proposal would be applicable as if included in the Tax Reform Act of 1984.

2. Clarify definition of Indian reservation under section 168(j)(6)

Present Law

Section 168(j)(6) provides for accelerated depreciation for certain property located on Indian reservations. For this purpose, provides that the term "Indian reservation" means a reservation as defined in either (a) section 3(d) of the Indian Financing Act of 1974 (25 U.S.C. 1452(d)), or (b) section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C. 1903(10)). In addition, section 45A (which provides for an incremental Indian employment credit) incorporates by reference the same definition of "Indian reservation" contained in section 168(j)(6). Section 3(d) of the Indian Financing Act of 1974 includes not only officially designated Indian reservations and public domain Indian allotments, but also all "former Indian reservations in Oklahoma," which covers most of the State of Oklahoma even though parts of such "former Indian reservations" may no longer have a significant nexus to an Indian tribe.

Description of Proposal

For purposes of the section 168(j)(6) definition of "Indian reservation," the term "former reservations in Oklahoma" would mean lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 51.

Effective Date

The proposal generally would be effective as if included in the Omnibus Budget Reconciliation Act of 1993 (i.e., the technical correction would apply to property placed in service and wages paid on or after January 1, 1994). However, the proposal would not apply to wages claimed on any original return filed prior to March 18, 1997, nor would it apply to property placed in service with a 10-year life or less (without regard to section 168(j)) if accelerated depreciation under section 168(j) was claimed with respect to such property on an original return filed prior to March 18, 1997.