DESCRIPTION OF CHAIRMAN'S MARK

TO H.R. 11

(REVENUE ACT OF 1992)

Scheduled for Markup

Before the

SENATE COMMITTEE ON FINANCE

on July 29, 1992

Prepared by the Staff

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee and the staff of the Senate Committee on Finance (Part II), provides a description of Chairman Bentsen's Mark to H.R. 11 (Revenue Act of 1992). The Committee on Finance is scheduled to mark up the proposal on July 29, 1992. H.R. 11 was passed by the House of Representatives on July 2, 1992, and was referred to the Finance Committee on July 21, 1992.

The Chairman's Mark is divided into 11 Parts:

I. Economic Development in Distressed Areas--Enterprise Zones;

II. Income Security Provisions;

III. Savings Incentives (IRAs);

IV. Other Economic Development Tax Provisions;

V. Economic Development Provisions of H.R. 3040 (Tax Extension Act of 1992) as Reported by the Finance Committee (with only proposed modifications described in this document);

VI. Taxpayer Bill of Rights 2;

VII. Provisions Relating to Contributions to Charities;

VIII. Simplification Provisions;

IX. Other Revenue Provisions;

X. Additional Revenue Provisions; and

XI. Technical Corrections (S. 750, with modifications).

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Chairman's Mark to H.R. 11 (Revenue Act of 1992) (JCX-28-92), July 28, 1992.

I. ECONOMIC DEVELOPMENT IN DISTRESSED AREAS-- ENTERPRISE ZONES

Present Law

The Internal Revenue Code does not contain general rules that target specific geographic areas for special Federal income tax treatment. Within certain Code sections, however, there are definitions of targeted areas for limited purposes (e.g., low-income housing credit and qualified mortgage bond provisions target certain economically distressed areas). In addition, present law provides favorable Federal income tax treatment for certain U.S. corporations that operate in Puerto Rico, the U.S. Virgin Islands, or a possession of the United States to encourage the conduct of trades or businesses within these areas.

Description of Proposal

Designation of tax enterprise zones

In general.--A total of 25 tax enterprise zones would be designated (subject to availability of eligible zones) during 1993-1996. Tax enterprise zones would be urban tax enterprise zones, rural development investment zones, or Indian reservation tax enterprise zones, and would be designated from areas nominated by State and local governments or a governing body of an Indian reservation.

The Secretary of Housing and Urban Development (HUD) would designate 15 urban tax enterprise zones (up to 6 zones designated in 1993, 4 zones in 1994, 3 zones in year 1995, and 2 zones in year 1996). Any shortfall in designations of zones may be carried forward to the next year, but not beyond 1996.

The Secretary of Agriculture (in consultation with the Secretary of the Interior) would designate 8 rural development investment zones (up to 3 zones designated in 1993, 2 zones in 1994, 2 zones in 1995, and 1 zone in 1996).[1] Any shortfall in designations of zones may be carried forward to the next year, but not beyond 1996.

The Secretary of the Interior would designate 2 Indian reservation tax enterprise zones (1 zone in 1993, 1 zone in 1994, and any shortfall carried forward through 1996).

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[1] Rural development investment zones would be located in areas which are (1) outside a metropolitan statistical area as defined by the Secretary of Commerce, or (2) determined by the Secretary of Agriculture, after consultation with the Secretary of the Interior, to be a rural area.

Nominated areas located on Indian reservations also would be eligible for designation (provided the bill's criteria are met) as rural development investment zones.

Zone designations generally would remain in effect for 10 years. An area's zone designation could be revoked if the local government or State significantly modifies the boundaries or does not comply with its agreed-upon course of action for the zone (described below).[2]

Eligibility criteria for zones.--The eligibility criteria for urban zones, rural zones, and Indian reservation zones generally would be the same (except as noted below). To be eligible for designation as a tax enterprise zone, a nominated area would be required to have all of the following characteristics: (1) a population of at least 20,000 (10,000 in the case of a rural zone and no minimum population for Indian reservation zones); (2) a condition of pervasive poverty, unemployment, and general economic distress; (3) is one contiguous area; (4) is located within not more than two States; (5) poverty rates of at least 25 percent in each of the area's census tracts[3]; (6) poverty rates of at least 35 percent in each of at least 80 percent of the area's census tracts; and (7) a satisfactory course of action (described below) adopted by the State and local governments designed to promote economic development in the nominated area.

Course of action.--In order for a nominated area to be eligible for designation as a tax enterprise zone, the local government and State in which the area is located would be required to agree in writing that they will adopt (or continue to follow) a specified course of action designed to reduce burdens borne by employers or employees in the area.

A course of action must include the following actions with respect to a nominated area: (1) certification by the State insurance commissioner (or similar official) that basic commercial property insurance of a type comparable to that insurance generally in force in urban or rural areas, whichever is applicable, throughout the State is available to businesses within the nominated area; (2) a program to ensure

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[2] An area's designation as a tax enterprise zone could be revoked only after a hearing on the record at which officials of the State and local governments are given an opportunity to participate and the State and local governments have an opportunity to correct any deficiencies found at the hearing.

[3] If areas are not tracted as population census tracts, the equivalent county divisions as defined by the Bureau of the Census for purposes of defining poverty areas would be treated as population census tracts.

the necessary rehabilitation of publicly owned property; (3) increase in the level, or efficiency of delivery, of local public services (such as public safety protection); (4) involvement in the program by public or private entities (e.g., community groups), including a commitment to provide jobs and job training, and technical, financial, or other assistance to employers, employees, and residents of the area; (5) special preferences granted to contractors owned and operated by socially and economically disadvantaged groups, in connection with activity in the zone; (6) certain programs to encourage local financial institutions to make loans to area businesses, with emphasis on locally owned and small-business concerns; and (7) special preferences for projects within the area in allocations of the State's low-income housing credit ceiling and private activity bonds ceiling.[4]

In addition, the required course of action may include the following: (1) a reduction of tax rates or fees applying within the zone; (2) donations of surplus land to community organizations agreeing to operate businesses on the land; and (3) programs to encourage employers to purchase health insurance for employees on a pooled basis.

Programs which serve as part of the required course of action could not be funded with proceeds from any Federal program (other than discretionary proceeds, such as community development block grants, the use of which is not restricted to a zone). In evaluating courses of action agreed to by the State or local government, past efforts of those governments with respect to the nominated area would be taken into account.

Selection process and criteria.--All designated tax enterprise zones would be selected from nominated areas on the basis of the following criteria (each of which would be given equal weight): (1) the strength and quality of promised contributions by State and local governments relative to their fiscal ability; (2) the effectiveness and enforceability of the guarantees that the promised course of action will be implemented, including the specificity with which the contributions enumerated in the course of action are described in order that it could be determined annually by the applicable Secretary whether such contributions actually are being carried out; and (3) the ranking (relative to other nominated areas) with respect to the poverty rate of the nominated area.

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4 Requirements would apply to an area located on an Indian reservation only to the extent that the reservation governing body has legal authority to comply with such requirements.

Tax incentives

Employer wage credit.--A 40-percent credit against income tax liability would be available to all employers for the first $20,000 of wages paid to each employee who (1) is a zone resident (i.e., his or her principal place of abode is within the zone), and (2) performs substantially all employment services within the zone in a trade or business of the employer.

The maximum credit per qualified employee would be $8,000 per year. Wages paid to a qualified employee would continue to be eligible for the credit if the employee earns more than $20,000, although only the first $20,000 of wages would be eligible for the credit.[5] The wage credit would be available with respect to a qualified employee, regardless of the number of other employees who work for the employer or whether the employer meets the definition of an "enterprise zone business" (which applies for the investment tax incentives described below).

Qualified wages would include the first $20,000 of "wages," defined to include (1) salary and wages as generally defined for FUTA purposes, and (2) certain training and educational expenses paid on behalf of a qualified employee, provided that (a) the expenses are paid to an unrelated third party and are excludible from gross income of the employee under present-law section 127, or (b) in the case of an employee under age 19, the expenses are incurred by the employer in operating a youth training program in conjunction with local education officials.

The credit would be allowed with respect to full-time and part-time employees. However, the employee must be employed by the employer for a minimum period of at least 90 days or 120 hours of service. Wages would not be eligible for the credit if paid to certain relatives of the employer or, if the employer is a corporation, certain relatives of a person who owns more than 50 percent of the corporation. In addition, wages would not be eligible for the credit if paid to a person who owns more than five percent of the stock (or capital or profits interests) of the employer.

To be eligible for the wage credit, an employer would be required to notify all employees of the advance refundability of the earned income tax credit (EITC).

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[5] To prevent avoidance of the $20,000 limit, all employers of a controlled group of corporations (or partnerships or proprietorships under common control) would be treated as a single employer.

For certain small employers, the credit would be refundable (and could be used to reduce tentative minimum tax). For this purpose, "small employers" would be defined as employers with gross receipts not greater than $2 million during the preceding taxable year, although refundability would be phased out for employers with gross receipts between $1 million and $2 million of gross receipts. For employers that are not "small employers," the credit would not be refundable. For such employers, the credit would be subject to the general business credit limitations (sec. 38) and, therefore, could not be used to reduce tentative minimum tax.

An employer's deduction otherwise allowed for wages paid would be reduced by the amount of credit claimed for that taxable year.

Expansion of targeted jobs tax credit (TJTC).--The present-law targeted jobs tax credit (sec. 51) would be expanded so that a person who resides in a tax enterprise zone automatically would be treated as a member of a targeted group for purposes of that credit.[6] Thus, employers located outside of enterprise zones would be entitled to claim the 40-percent TJTC credit on up to $6,000 of qualified first-year wages paid to employees who reside within a tax enterprise zone.[7]

As under present-law, an employer's deduction otherwise allowed for wages paid would be reduced by the amount of TJTC claimed for that taxable year.

Definition of "enterprise zone business".--The investment tax incentives described below (but not the labor incentives described above) would be available only with respect to trade or business activities that satisfy the criteria for an "enterprise zone business." Under the proposal, an "enterprise zone business" would be defined as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within a tax enterprise zone[8]; (2) at

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6 The TJTC expired on June 30, 1992, but would be extended for 18 months (i.e., through December 31, 1993) by another proposal contained in the Chairman's Mark.

7 Employers located within a tax-enterprise zone would not be allowed to claim the TJTC with respect to an employee if any of such employee's wages were taken into account in determining the employer's enterprise zone wage credit.

8 This requirement would not apply to a business carried on by an individual as a proprietorship.

least 80 percent of the total gross income is derived from the active conduct of a qualified business within a zone; (3) substantially all of the use of its tangible property occurs within a zone; (4) substantially all of its intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within a zone; (6) at least one-third of the employees are residents of the zone; and (7) no more than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" would be defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license. In addition, the leasing of real property that is located within the tax enterprise zone to others would be treated as a qualified business only if (1) the leased property is not residential property, and (2) substantially all of the property is leased to an enterprise zone business. The rental of tangible personal property to others would not be a qualified business unless substantially all of the rental of such property is by enterprise zone businesses or by residents of a tax enterprise zone.

Activities of legally separate (even if related) parties would not be aggregated for purposes of determining whether an entity qualifies as an enterprise zone business.

Increased section 179 expensing.--The present-law $10,000 expensing allowance for certain depreciable business property provided under section 179 would be increased to $75,000 for enterprise zone businesses (as defined above). In addition, the types of property eligible for section 179 expensing would be expanded to include buildings used in enterprise zone businesses.

"Qualified zone property" would be defined as depreciable tangible property (including buildings), provided that: (1) such property was acquired by the taxpayer (but not from a related party) after the zone designation took effect; (2) the original use of the property in the zone commences with the taxpayer; and (3) substantially all of the use of the property is in the zone in the active conduct of a trade or business by the taxpayer in the zone. In the case of property which is substantially renovated by the taxpayer, however, such property need not be acquired by the taxpayer after zone designation nor originally used by the taxpayer within the zone if during any 24-month period after zone designation the additions to the taxpayer's basis in such property exceed 100 percent of the taxpayer's basis in such

property at the beginning of the period or $5,000 (whichever is greater).

As under present law, the section 179 expensing allowance would be phased out for certain taxpayers with investment in depreciable business property during the taxable year above a specified threshold. However, the present-law phaseout range (i.e., $200,000 to $210,000 of investment during the taxable year) would be increased for enterprise zone businesses to a phaseout range of $300,000 to $450,000 of investment made by the taxpayer during the taxable year.

In the case of an enterprise zone business that is a component member of a controlled group of corporations, the $75,000 expensing allowance would apply only if all component members of the group are enterprise zone businesses. As under present law, the $75,000 expensing allowance is to apply at both the partnership and partner level.

The increased expensing allowance would be allowed for purposes of the alternative minimum tax (i.e., it would not be treated as an adjustment for purposes of the alternative minimum tax). The section 179 expensing deduction would be recaptured if the property is not used predominantly in a enterprise zone business (under rules similar to present-law section 179(d)(10)).

Accelerated depreciation.--An enterprise zone business (as defined above) would determine depreciation deductions with respect to "qualified zone property" (also defined above) by using the following recovery periods:

3-year property	2 years
5-year property	3 years
7-year property	4 years
10-year property	6 years
15-year property	9 years
20 year property	12 years
Nonresidential real property	20 years

The shorter recovery periods allowed for qualified zone property of enterprise zone businesses would not be allowed for alternative minimum tax purposes.

Ordinary loss treatment.--Loss incurred by an individual or corporate taxpayer on disposition of certain property used in an enterprise zone business would be treated as ordinary loss. The proposal would apply to property used in an enterprise zone business for at least two years (five years in the case of real property). Loss on disposition of a stock or partnership interest in an enterprise zone business held by an individual for at least two years would be treated as ordinary loss. Ordinary loss treatment would not be

available for intangible property, other than stock or partnership interests in enterprise zone businesses.

Stock interests eligible for the ordinary loss treatment would have to be acquired by the individual taxpayer on original issue from the corporation solely in exchange for cash at a time when the corporation was an enterprise zone business (or was being organized for the purpose of being an enterprise zone business), and during substantially all of the taxpayer's holding period, the corporation qualified as an enterprise zone business.[9] Similar rules would apply to partnership interests in enterprise zone businesses. Property used in an enterprise zone business would be eligible for the ordinary loss treatment if (1) it meets the definition of qualified zone property (defined above), or (2) it is land which is an integral part of an enterprise zone business.

The ordinary loss treatment would apply only to losses that are attributable to the period that the property is used in an enterprise zone business. Losses from transactions with related persons would not be eligible for the ordinary loss treatment.

The ordinary loss treatment would apply for purposes of computing regular and alternative minimum tax.

Stock expensing.--An individual would be allowed a 50-percent deduction for the amount paid in cash during any taxable year to purchase certain stock in an enterprise zone business. The amount of the deduction would be limited to $25,000 per year (with a $250,000 lifetime cap).[10]

Stock would qualify for the expensing deduction only if it was stock acquired on original issue from a domestic C corporation that: (1) meets the definition of an enterprise zone business (defined above); (2) does not have more than one class of stock outstanding; (3) the sum of (a) the unadjusted bases of the assets owned by the corporation and (b) the value of leased assets does not exceed $3 million; (4) more than 20 percent of the total value and total voting power of the stock of the corporation is owned by individuals (directly or through partnerships or trusts) or by estates; and (5) the cash paid for the stock is used by the issuing

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[9] Stock would not be eligible for the ordinary loss treatment if the basis of such stock had been reduced under the stock expensing provision described below.

[10] Thus, in order for an individual to claim the maximum $25,000 per-year deduction, the individual would have to purchase $50,000 of qualified stock during the taxable year.

corporation within 12 months to acquire property (a) which is depreciable tangible property (whether real or personal) to which section 168 applies, (b) the original use of which in the zone commences with the issuing corporation, and (c) substantially all of the use of which is in the zone.

For purposes of the $25,000 annual limitation and the $250,000 lifetime cap, an individual and certain members of his family would be treated as a single individual.

The basis of stock would be reduced by the amount of the deduction. In addition, gain on disposition of the stock would be treated as ordinary income to the extent of the amount allowed as a deduction, and interest would be payable on certain premature dispositions. The deduction would be allowed for purposes of the alternative minimum tax.

Tax-exempt financing.--Bonds used to finance certain enterprise zone facilities would constitute a new category of exempt facility bonds, subject to the current State private activity volume cap, but at a reduced rate. Only 50 percent of the amount of qualified enterprise zone bonds issued would count against the State private activity volume cap.

Qualified enterprise zone facilities in "enterprise zone eligible areas" would qualify for tax-exempt bond finance, whether or not these areas were actually designated as an enterprise zone. Qualified enterprise zone facilities would include land, plant, and equipment used by enterprise zone businesses (as defined above) but would not include housing (rental or owner-occupied). Rules similar to those in Section 144(a)(8)(B) would apply to the types of facilities that could be financed with enterprise zone bonds. The proceeds of qualifying enterprise zone bonds would be required to be spent within 18 months of the date of issuance. An enterprise zone business would be eligible for up to an aggregate of $1 million in enterprise zone bond financing.

The appropriate Secretary would be responsible for certifying that an area was "enterprise zone eligible" in a timely manner after receiving the area's nominating petition. Enterprise zone bonds could be issued during the two-year period following this designation. Such bonds would remain tax-exempt regardless of whether the area continued to meet the criteria for being "enterprise zone eligible" or the business continues to be an enterprise zone business. In cases where the business receiving enterprise zone bond financing ceases to be an enterprise zone business, certain penalties would be imposed on such a business.

For purposes of the so-called bank deductibility rules for interest costs of carrying tax-exempt bonds (ec. 265), enterprise zone bonds would be treated comparable to bonds

issued by a "qualified small issuer."

<u>Low-income housing credit (LIHC) expansion</u>.--For purposes of the low-income housing credit (sec. 42)[11], tax enterprise zones would automatically qualify as "difficult to develop" areas, within which the eligible basis of buildings for purposes of computing the credit is 130 percent of the cost basis. (Thus, the credit would be based on 91 percent of present value instead of the regular LIHC rate of 70 percent of present value.) The present-law State credit cap would continue to apply.

Rules

Within four months after the date of enactment, the Secretaries of HUD, Agriculture, and Interior would be required to promulgate rules (by notice or regulation) regarding: (1) procedures for nominating areas for designation as tax enterprise zones; (2) the method for comparing the enumerated selection criteria; and (3) recordkeeping requirements to assist in the preparation of studies to be submitted to Congress (described below). Such rules would provide that State and local governments shall have no less than five months after issuance to submit their applications for zone designation before such applications are evaluated and compared and any area is designated as a tax enterprise zone.

Studies

A study would be conducted under the auspices of the National Academy of Sciences, analyzing the effectiveness of the tax enterprise zone provisions. An interim report of this study would be required to be submitted to Congress by July 1, 1997, and a final report by July 1, 2000.

Effective Date

Tax enterprise zone designations would be made only during calendar years 1993 through 1996. The tax incentives provided for would be available during the period that the designation remains in effect, which generally would be for 10 years after the designation first becomes effective.

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11 The low-income housing credit expired on June 30, 1992, but would be extended for 18 months (i.e., through December 31, 1993) by another proposal contained in the Chairman's Mark.

II. INCOME SECURITY

A. FOSTER CARE; SUBSTANCE ABUSE PREVENTION AND TREATMENT

1. Foster Care, Adoption, and Family Services

Funding for Foster Care Related Services

Present Law

Title IV-B of the Social Security Act authorizes $325 million a year to be used by the States to provide child welfare services. The fiscal year 1992 appropriation for child welfare services is $273.9 million. States generally have broad discretion in determining the nature of the services they wish to provide, and the population to which they will be provided. The Federal matching share is 75 percent. Funds are allocated to the States under a formula that takes into account the State's relative number of children under age 21 and per capita income.

States are not required to report how they use title IV-B funds, and there are no official data available at the Federal level that show the purposes for which States are using Federal dollars. States may provide services without regard to family income.

Proposed Change

Funding. - Title IV-B is amended to provide entitlement matching funds to States to enable them to develop and provide innovative services programs aimed at preventing unnecessary placement in foster care; helping families to be reunited after a child has been in foster care; promoting planned, permanent living arrangements for children who have been placed in foster care, including placement in adoption, where appropriate; and other family support services that the State may choose to provide.

States will be entitled to their share of $150 million in fiscal year 1993, $250 million in fiscal year 1994, and $300 million in fiscal year 1995, $350 million in fiscal year 1996, and $400 million in fiscal year 1997 and years thereafter. The Federal matching share will remain at 75 percent. Allotment of funds will be on the same basis as is used under the current title IV-B program (which reflects the size of the State's population under age 21 and per capita income).

Services. - Funds may be used for the planning, development, expansion, and operation of the following services:

(1) preplacement preventive services designed to help children at risk of foster care placement remain with their families (including adoptive families) where appropriate;

(2) reunification services designed to help children return to the families (including adoptive families) from which they have been removed, where appropriate;

(3) followup services designed to sustain and further strengthen families (including adoptive families) after a child has returned home from foster care placement;

(4) where appropriate, services to help children be placed for adoption, with a legal guardian, or, if adoption or legal guardianship is determined not to be appropriate for a child, in some other planned, permanent living arrangement;

(5) respite care to provide assistance for any foster care family or adoptive family and any other family that the State agency determines needs such care in order to preserve family stability, with priority to the family of a child with a medical condition or physical, mental, or emotional handicap that requires special assistance (as determined by the Secretary); and

(6) family support services to strengthen the functioning of a family (including an adoptive or foster care family), including services designed to improve parenting skills.

Evaluation. - An authorization of $8 million a year for five years will be provided to enable the Secretary of HHS to evaluate State programs receiving funds under this program. The Secretary will be allowed to conduct these evaluations through contracts with independent research organizations.

States may also use funds available to them under the new Part B funding authority to conduct their own evaluations of their services programs under regulations of the Secretary.

The Secretary must develop procedures to facilitate the coordination of evaluation efforts undertaken by HHS and by the States and must provide technical assistance to the States in planning and designing their evaluations.

In designing the evaluations conducted by the Department of HHS, the Secretary must consult with representatives of organizations representing State and local program administrators; private, nonprofit organizations with an interest in child welfare; and with individuals and organizations that have experience in evaluating child welfare or other related services programs.

Evaluations by the Secretary and by the States must use outcome measures of children and families that can be compared with similar outcome measures of children and families that did not receive these services. The Secretary must assure that an appropriate portion of the evaluations conducted by him will use experimental and control groups.

Beginning in fiscal year 1995, the Secretary must issue an annual report to the Congress on the status and findings of all evaluations undertaken by the Department. The report shall also include a summary description of State evaluations paid for with these Federal funds.

By December 1, 1996, based on evaluations conducted by the Secretary and the States, the Secretary must submit a report to the Ways and Means and Finance Committees with recommendations for legislation to improve services provided to families and children under title IV-B so as to strengthen families, to reduce the number of cases in which it is necessary to remove a child from home and place the child in foster care, to promote the reunification of families of children who have been placed in foster care, and to promote planned, permanent living arrangements for children, including adoption, where appropriate.

State plan/reporting requirements. - In order to receive funding for services, each State must submit, on an annual basis, an amendment to its title IV-B plan. The plan amendment must be approved by the Secretary, and must include a detailed description of how the State intends to use its share of the new money. In addition, the State must submit an annual report to the Secretary that summarizes activities actually carried out with funds made available under this legislation. The State must also develop a statement of goals that it expects to achieve over the 5-year period 1993-1997, which must be submitted to the Secretary by January 1, 1993.

State maintenance of effort. - As a condition of receiving funds under this program, States must provide the Secretary with written assurances that State and local funds expended for the purpose of providing child welfare services (excluding foster care maintenance and adoption assistance payments) will be maintained at a level that equals or exceeds the level of funding for these services in fiscal year 1991.

Measures to Improve Coordination of Services

Present Law

There are a large number of categorical programs serving families and children. However, little systematic effort has been made to coordinate them at the Federal, State, or local level.

Proposed Change

The proposal provides governors with an incentive to develop programs to improve the coordination of child and family services at the State and local levels of government. As an incentive, beginning October 1, 1992, the Secretary will be required to

permit up to 15 States to use Federal title IV-E foster care administrative (entitlement) matching funds (not to exceed $3 million per year for any one State) to conduct pilot projects to improve the coordination of assistance for families and children. Applications for approval of projects must be submitted by the Governor.

Projects may last up to three years. They must provide for improved coordination of the child welfare, foster care, and adoption assistance programs with several or all of the following programs designed to assist families and children: programs under the Social Security Act (Aid to Families with Dependent Children, Child Support Enforcement, JOBS, Medicaid, and Maternal and Child Health), WIC, education programs, mental health programs, juvenile justice programs, substance abuse programs, programs for the developmentally disabled, and other programs determined by the State and approved by the Secretary.

Any State approved by the Secretary to operate such a demonstration project will be required to conduct an evaluation and report the results of the evaluation to the Secretary. States may use regular IV-E administrative/placement matching funds for evaluation.

States receiving grants will be required to identify both Federal and State legislative and non-legislative policies (including administrative structures) that impede or inhibit coordination of the delivery of services to families and children. States must provide the Secretary with information on the steps they have taken or intend to take to eliminate or reduce problems in coordination that result from State or local statutes and policies. They must also provide the Secretary with information on barriers they have identified in Federal legislation and policy that limit States' ability to coordinate services for families and children.

The Secretaries of HHS, Agriculture, and Education, and the Attorney General, will be required to review Departmental policies to determine what changes in regulations and procedures can be made without legislative changes to improve coordination of services for children and families at the Federal, State, and local levels. In undertaking this review, they must consult with representatives of State and local governments.

A report including recommendations for making both legislative and nonlegislative changes to improve coordination must be submitted to the Congress by July 1, 1993, and must include a description of any technical assistance that the Departments will provide to the States to assist them in program coordination.

Measure to Facilitate Adoption

Present Law

Under present law, there must be a review of the status of each foster care child at least every six months by a court or by an administrative panel to determine the necessity for and appropriateness of the child's placement in foster care, as well as the extent of progress that has been made toward alleviating or mitigating the causes necessitating placement in foster care, and to project a likely date by which the child may be returned to the home or placed for adoption or legal guardianship.

Proposed Change

Present law is amended to require, in the case of a child who is legally free for adoption, that the court or administrative body conducting the case review must determine and document for the child the specific steps being taken by the State agency to find an adoptive family for the child, or must make a finding that adoption placement would be inappropriate for the child. This provision is effective January 1, 1994.

Federal Matching for Certain Adopted Children

Present Law

Title IV-E provides Federal matching for foster care maintenance payments made on behalf of an AFDC-eligible child. If the foster child is subsequently adopted by a family that is not an AFDC family, and that adoption is disrupted, the child is no longer considered to be an AFDC-eligible child. Therefore, when the child returns to foster care, it is no longer eligible for Federally-matched foster care payments, and is also not eligible for adoption assistance payments if it is placed for adoption with a second family.

Proposed Change

Beginning October 1, 1992, States will be allowed to claim title IV-E matching in the case of a child who has previously been determined to be eligible for adoption assistance payments under title IV-E, but who has returned to foster care because the adoption has been set aside by the court. The child would be eligible for foster care maintenance payments, as well as for adoption assistance to facilitate adoption by a second family.

Tax Deduction for Costs of Adopting a Special Needs Child

Present Law

Taxpayers are not allowed to deduct expenses related to adopting a child in determining their Federal income tax liability.

Proposed Change

Taxpayers may deduct certain allowable expenses (up to a maximum of $3000) of adopting a special needs child. Allowable expenses include reasonable and necessary adoption fees, court costs, attorneys fees, and other expenses directly related to the legal adoption of the child which are eligible for reimbursement under the Title IV-E adoption assistance program. A special needs child is a child with respect to whom the State has determined that there exists a specific factor or condition (such as ethnic background, age, or membership in a minority or sibling group, or medical condition or physical, mental, or emotional handicap) that makes it difficult to find an adoptive home for the child.

The provision is effective for adoptions occurring after December 31, 1992.

Study of "Reasonable Efforts"

Present Law

In order for a State to be eligible for title IV-E funding, the State plan must specify that, in each case, reasonable efforts will be made prior to the placement of a child in foster care to prevent the need for foster care and make it possible for the child to return home (sec. 471(a)(15)). The statute also provides that for each child entering foster care after October 1, 1983, a judicial determination must be made that there were reasonable efforts to prevent placement in foster care (sec. 472(a)(1)).

Proposed Change

Not more than 90 days following enactment, the Secretary of HHS must establish an Advisory Committee to study the implementation of the current law requirement that reasonable efforts must be made to prevent the need for removal of a child from the child's home, and to make it possible for the child to return home. The Advisory Committee must submit a report to the Secretary, the Congress, and the President with recommendations for improving the implementation of this requirement by January 1, 1994.

The Advisory Committee shall consist of no fewer than 9 members and shall include representatives of: private, nonprofit organizations with an interest in child welfare (including organizations that provide child protective, foster care, or adoption services); hospitals with a significant number of boarder babies; State and local public agencies with responsibility for child protective, foster care, or adoption services; and State and local judicial bodies with jurisdiction over family law.

Require Placement in Least Restrictive, Most Appropriate Setting

Present Law

Current law (sec. 475(5)(A)) requires that each State's child welfare and foster care programs must provide for a case plan for each foster care child that is designed to achieve placement in "the least restrictive (most family like), setting available and in close proximity to the parents' home, consistent with the best interests and special needs of the child."

Proposed Change

The current law requirement specifying that each child must have a case plan designed to achieve placement in "the least restrictive (most family like), setting available and in close proximity to the parents' home, consistent with the best interests and special needs of the child" will be modified to require placement in "the least restrictive (most family like) <u>and most appropriate,</u> setting available and in close proximity to the parents' home, consistent with the best interests and special needs of the child". The provision is effective January 1, 1993.

Demonstration Projects to Facilitate Return Home for an AFDC Child

Present Law

Under present law, if a child is removed from an AFDC home and placed in foster care, the family is not eligible for an AFDC payment on behalf of the child until the month that the child returns home. If the child is the only dependent child in the family, the family will not be eligible for any AFDC payment until the month that the child returns home.

Proposed Change

The Secretary of HHS shall enter into an agreement with up to 6 States to conduct demonstration projects to test and evaluate whether family reunification can be facilitated by allowing a family to receive AFDC for the month prior to the

month in which a child returns home from foster care (in an amount which the family would be eligible to receive if the child were living in the home). For that month, States may also provide for a payment to meet special needs, such as a bed or other furniture or equipment that the child may need. Demonstration projects may last up to 3 years. No project may be conducted after January 1, 1997.

Enhanced Federal Funding for Data Collection Systems

Present Law

There is no provision for enhanced Federal matching to encourage States to develop and install statewide data collection and information retrieval systems to administer the title IV-B and title IV-E programs, or for implementing a provision included in the 1986 Budget Reconciliation Act requiring States to establish Statewide information systems.

The 1986 legislation included an amendment mandating certain studies and reports to Congress related to the feasibility of establishing a system for the collection of certain foster care and adoption data. The amendment, which added a new section 479 to the Social Security Act, required the Secretary of HHS to establish an Advisory Committee on Adoption and Foster Care Information.

On October 1, 1987, the Advisory Committee submitted to the Congress the results of a study which identified the types of data necessary to assess on a continuing basis the incidence, characteristics and status of adoption and foster care. On May 26, 1989, the Secretary of HHS submitted to Congress a report, due on July 1, 1988, proposing a method of establishing, administering and financing a system for the collection of data relating to adoption and foster care in the United States. However, HHS has not yet promulgated regulations providing for the implementation of the information system. The law requires final implementation of the system no later than October 1, 1991.

Proposed Change

Effective January 1, 1993, States may claim 90 percent Federal matching funds for costs of planning, designing, developing, or installing a statewide data collection and information retrieval system (including the full cost of the hardware components of such system) that is approved by the Secretary for purposes of administering the title IV-B child welfare and title IV-E foster care and adoption assistance programs, and that meets the requirements of section 479.

To be eligible for Federal matching funds, a system must be determined by the Secretary as likely to provide more efficient, economical, and effective administration of the title IV-E and

title IV-B programs.

Matching will be available until September 30, 1995, by which time a system meeting the requirements of section 479 must be in place. Systems must be capable of interfacing with the State's AFDC system to verify AFDC eligibility of a foster care child. Title IV-E Federal administrative matching funds may be used to pay for operating costs with respect to IV-E eligible children. Title IV-B funds may also be used to pay for operating costs (although they may not be used to draw down IV-E matching funds).

Extend and Improve the Independent Living Program

Present Law

In 1985 the Committee on Finance approved the establishment of the Independent Living Program to help youths make the transition from foster care to independent living. The amendment was included in the Budget Reconciliation Act of 1985. As amended, it allows States to provide services to all youths age 16 who are in foster care, including those who are not receiving title IV-E maintenance payments. States may also provide services to youths up to age 21 whose foster care payments ceased after they attained age 16.

Independent living program services may include those that enable participants to seek a high school diploma or take part in vocational training; provide training in daily living skills, budgeting, locating housing and career planning; provide for counseling; coordinate services; establish outreach programs; and provide an independent living plan in the youth's case plan.

The statute authorizes $50 million dollars in entitlement funding for fiscal year 1990 (increased from $45 million in prior years); $60 million in 1991; and $70 million in 1992. For fiscal years 1991 and 1992, States are required to provide 50 percent Federal matching for amounts above $45 million. The program is not authorized beyond fiscal year 1992.

Proposed Change

The Independent Living Program, designed to assist foster care youths in making the transition from foster care to independent living, will be modified to:

(1) extend the program permanently; and

(2) allow youths in independent living programs to accumulate assets sufficient to enable them to establish their own households (as determined by the State agency) without losing eligibility for maintenance payments or Medicaid.

These provisions are effective October 1, 1992.

Improvements in Child Welfare Training

Present Law

Title IV-B of the Social Security Act (section 426(a)(C)) authorizes such sums as may be necessary to enable the Secretary of Health and Human Services to make grants to public or private nonprofit institutions of higher education for training personnel for work in the field of child welfare.

Proposed Change

The current child welfare statute authorizing Federal funding for child welfare training is amended to ensure that students who receive training under this provision actually work in the child welfare system, and to make students and institutions more accountable for the use of funds by reinforcing the link between child welfare study and actual practice in the child welfare field. The amendment would:

(1) require students receiving stipends to: participate in a related field placement on a regular basis, and to commit to and complete full-time post-graduation employment in a public or private non-profit child welfare agency (one year for each year of support received);

(2) require institutions receiving funds to: provide appropriate student supervision and support, including formal agreements with local child welfare agencies for the onsite training of recipients; develop and implement curricula which reflect current knowledge about best practices in delivering child welfare services, and consult with child welfare agencies in developing such curricula; and implement a system to track (for a period of three years) students who receive training in family and child welfare services to determine the percentage of trainees who secure and retain employment in the child welfare field; and

(3) allow those already working in the child welfare system (including either a public or private non-profit agency) to be eligible for stipends in order to complete degree requirements.

These provisions are effective for grants awarded after January 1, 1993.

In addition, the Secretary of HHS is required, not later than April 1, 1993, to publish final regulations establishing guidelines to assist States in using Federal matching funds that are authorized under current law for the purpose of providing training for individuals who are employed or preparing for employment by State and local child welfare agencies.

The Secretary is also required to develop and publish a model staff recruitment, training, and staff retention program for use by such agencies, by April 1, 1993.

The present law authority to match State expenditures for training of foster and adoptive parents and for training staff of approved child care institutions providing care to foster and adopted children, which will expire at the end of fiscal year 1992, is extended for three years.

Health Care Plans for Foster Children

Present Law

The State agency is required to have a case plan for each foster child in its care. The case plan must include, to the extent available and accessible, the health and education records of the child, including the names and addresses of the child's health and educational providers; the child's school record; a record of the child's immunizations; the child's known medical problems; and other relevant health and education information concerning the child.

Proposed Change

Each child's case plan must also include a record indicating that the child's foster care provider was advised (where appropriate) of the child's eligibility for early and periodic screening, diagnostic, and treatment services under title XIX (Medicaid). The provision applies to case plans established or reviewed on or after January 1, 1993.

Participation by Citizen Review Volunteers

Present Law

The statute requires the review of the status of each child in foster care no less frequently than every six months by either a court or by administrative review to determine the continuing necessity for and appropriateness of the placement, the extent of compliance with the case plan, and the extent of progress which has been made toward alleviating or mitigating the causes necessitating placement in foster care, and to project a likely date by which the child may be returned to the home or placed for adoption or legal guardianship.

In addition, each child in foster care must have a dispositional hearing held in a court of competent jurisdiction or by an administrative body appointed or approved by the court within 18 months after the original placement, and periodically thereafter, to determine the future status of the child.

Currently, 22 States use citizen volunteers to review foster care cases and to make recommendations at administrative reviews and court hearings. There is no specific statutory language authorizing citizen participation in these processes.

Proposed Change

The statute is amended to specify that, to the extent determined appropriate by the State, case reviews shall include the participation by citizen volunteers in making recommendations at either the court or administrative reviews and dispositional hearings described above.

Demonstration Projects

Present Law

There is no specific statutory authority for demonstration projects under the child welfare, foster care and adoption assistance programs.

Proposed Change

The Secretary of Health and Human Services is authorized to approve up to 10 demonstration projects under which States will be given more flexible spending authority and will not be required to meet certain requirements of the child welfare and foster care programs.

Demonstrations may include:

(1) projects to prevent family dissolution;

(2) projects to promote reunification of a foster child with the child's own family;

(3) projects to expedite permanent placement of children who are in foster care, are boarder babies, were abandoned at or shortly after birth, have parents addicted to drugs, or were abused;

(4) projects to train individuals who live in a community to provide family support services to other families in the community with children at risk of being placed in foster care, using services which are based on a self-help model;

(5) Projects that provide "adult mentoring" services from adult volunteers to at-risk children or young adults who are in need of additional, on-going contact with adult role models; or

(6) projects to test an innovative approach to other significant child welfare services issues.

Projects may be statewide or may be operated in part of a State. The Secretary must approve at least 2 and not more than 4 applications by States with populations of less than 1.5 million; at least 3 and not more than 5 by States with populations between 1.5 and 7 million, and at least 2 and not more than 4 by States with populations over 7 million. The Secretary must approve no more than 4 applications for any one geographical region of the country.

States that apply for demonstration grants must commit to carrying out the project for not less than two and not more than five consecutive fiscal years.

States that are approved to conduct Statewide demonstration projects will receive a grant that reflects the sum of the amount paid to the State for fiscal year 1992 for child welfare services and foster care; the State's share of any increase in the appropriation for the child welfare program over the level for 1992; and 20 percent of the amount that would have been payable to the State for the immediately preceding fiscal year under the child welfare program if the State were not authorized to conduct a demonstration project. (For projects that are not Statewide, these amounts will be adjusted to reflect the portion of the State's foster care caseload that is within the area being served by the demonstration.)

All demonstrations must be evaluated by an entity or entities selected by the Secretary. The cost of evaluations (over and above ordinary State reporting costs) will be paid by the Secretary.

In addition, the State of New York would be allowed to conduct a deficit-neutral demonstration project aimed at facilitating the discharge of children from foster care, including the appropriate reunification of children with their families, or the adoption of children by suitable adoptive parents. In order for the demonstration to be approved, the State must agree to conduct an evaluation approved by the Secretary.

Quality Reviews

Present Law

Section 427 of the Social Security Act sets forth specified child protections that must be in place in order for a State to receive its allotment of appropriated title IV-B (child welfare) funds in excess of $141 million. These "incentive funds" have grown in importance, rising from just 10 percent ($15.3 million) of the total amount appropriated for title IV-B in 1982, to 49 percent ($132.9 million) of the appropriation for 1992.

In 1980, following the enactment of the Adoption Assistance

and Child Welfare Act of 1980, the Department of Health and Human Services identified a total of 18 child protections required by section 427. In what came to be known as "427 reviews," the caseload of each State receiving incentive funds is examined to determine compliance with these child protections. States are not required to initiate this review process, but nearly all States have elected to do so.

Three separate case record surveys are conducted in each State (an initial, subsequent, and triennial review) by a team composed of Federal, regional, and State personnel. Each of these reviews demands a higher level of compliance, and a State must have successfully passed the preceding review before proceeding to the next one.

If a State is found out of compliance, the Department issues a disallowance against the State's allotment of incentive funds for the coming fiscal year. States may appeal the disallowance to the Departmental Appeals Board, but the Department routinely withholds from a State the amount of the disallowance until the appeals process is completed.

The "427 review" process has been criticized on various grounds, and the Congress several times has acted to restrict HHS from disallowing Federal funds because a State failed a review.

In addition to the "427 reviews," the Department reviews expenditures made under the tile IV-E foster care and adoption assistance programs. Section 471(a)(13) requires States to arrange for periodic and independent audits of their activities under titles IV-B and IV-E at least every three years. Section 471(b) allows the Secretary to withhold or reduce payments to States upon a finding that a State plan no longer complies with State plan requirements, or, in the State's administration of the plan, there is substantial failure to comply with its provisions.

In practice, the Secretary may disallow expenditures for Federal reimbursement under title IV-E as a result of several review procedures. These include audits conducted pursuant to section 471(a)(13); audits conducted by the HHS Inspector General; regional office reviews of quarterly expenditure reports submitted by States as part of the claims reimbursement process; or Federal financial reviews. States may appeal disallowances to the Departmental Appeals Board.

Proposed Change

The Secretary of Health and Human Services is required to submit to the Committee on Finance and the Committee on Ways and Means recommendations for legislation to establish a system for (1) the review of each State child welfare program, and (2) the provision of technical assistance to State programs. The term "child welfare program" is defined to mean all activities engaged

in by the State under parts IV-B and IV-E of the Social Security Act.

Recommendations must include provisions requiring each State child welfare program to be reviewed periodically to determine whether and the degree to which the program complies with State plan requirements, and the extent to which the amounts claimed to have been expended by the State for foster care maintenance payments and adoption assistance are eligible for Federal reimbursement. In addition, recommendations must specify the criteria that are to be used to assess whether the State's program has complied with Federal requirements, and the degree of such compliance.

In developing the recommendations, the Secretary must consult with representatives of State agencies administering child welfare programs; representatives of private, nonprofit organizations which have an interest in child welfare; and such other individuals as the Secretary may determine. The recommendations are due prior to May 1, 1993.

The provision of the Omnibus Budget Reconciliation Act of 1989 that prohibits the Secretary from collecting any funds from States as a result of a disallowance made in connection with a section 427 triennial review for any year prior to 1991 would be amended to extend the prohibition to apply to any fiscal year prior to 1993. In addition, the prohibition would apply to all reviews, not just triennial reviews.

The Department of HHS would be required to pay claims as submitted by a State within 90 days of receipt unless a deferral or disallowance has been issued within that time period.

Commission on Childhood Disability

Present Law

The Social Security definition of disability that is applicable to adults in both the Title II Disability Insurance and Title XVI Supplemental Security Income programs requires that an individual be unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to last at least 12 months or result in death. To be found disabled, an adult must have impairments that either meet or equal published listings of severely disabling conditions, or be found because of a combination of medical and vocational factors (age, education, work experience) to be unable to engage in any kind of substantial work.

The SSI program which provides for benefits to disabled children under age 18, modifies this definition by providing that a child is disabled if he or she suffers from any medically

determinable physical or mental impairment "of comparable severity" to adult disabling impairments. Prior to the Supreme Court decision in the Zebley case, SSA published childhood medical listings of impairments that children had to meet or equal to be found disabled. Zebley required that SSA revise its regulations to provide for the childhood equivalent of vocational factors used in the determination of adult disabilities. SSA published regulations in February, 1991 that require the assessment of children's abilities to engage in age appropriate activities. This assessment is required to determine if children are disabled in circumstances where their impairments are severe but do not meet or equal the medical listings.

Proposed Change

The Secretary of Health and Human Services would be required to establish a 15 member Commission on the Evaluation of Disability in Children within 90 days of enactment. The Commission would be charged, in consultation with the National Academy of Sciences, with conducting a study of the definition of disability as it applies to children.

The Commission would be composed of recognized experts in fields of medicine dealing with children, psychology, education and rehabilitation, law, disability program administration, and other fields of expertise as determined by the Secretary. It would be required to report its findings and recommendations, including any recommendations for legislative or administrative change, to the Committee on Finance and the Committee on Ways and Means by September 1, 1994.

2. Substance Abuse Prevention and Treatment Programs

Present Law

Neither title IV-B (Child Welfare Services program) nor title XIX (Medicaid) currently provides for the establishment of comprehensive substance abuse prevention and treatment programs for pregnant women and parents with children.

Proposed Change

Title IV-B is amended to authorize $75 million for fiscal years 1993 and 1994, $100 million for fiscal years 1995 and 1996, and $125 million for fiscal year 1997 in entitlement matching funds to pay for non-medical substance abuse treatment support services for pregnant women and caretaker parents with children. Support services include home visitation services, nutrition services, child care, and parenting education; substance abuse prevention, treatment, and followup services; and any other services determined by the State to be necessary and appropriate to support the participation of an individual in the program. Funds may also be used for the costs of developing and

administering a program.

Funds are allocated to States under the same formula that is used for other title IV-B services (which reflects per capita income and child population). Federal matching is at the Medicaid matching rate. The Governor is given the authority to determine which agency in the State will administer the programs.

Medicaid-eligible pregnant women and caretaker parents and their children will be eligible for both existing medical services (funded through the Medicaid program) and substance abuse treatment support services (funded through the new title IV-B program). The State may also use these new funds to pay for support services to other low income pregnant women and caretaker parents and their children, regardless of their eligibility for Medicaid. States are required to give priority for participation in these programs to individuals who are referred to them by the State child welfare agency.

In order to be eligible for funds, the Governor must provide the Secretary of HHS with assurances that services provided with these funds will be coordinated with services provided under the Medicaid and Maternal and Child Health programs, and must report annually on the status of the programs funded under this title. States must also maintain their current level of spending for substance abuse treatment support services.

To be eligible for Federal funding, a program must make available (either directly or through arrangements with others) substance abuse prevention, treatment, and follow-up services; prenatal, gynecological, and pediatric medical services; home visitation; nutrition services; transportation services; child care; parenting education; and such other social and medical services as are determined to be necessary by the State and are allowed under regulations of the Secretary. Services may be provided in either residential or non-residential facilities.

The creation of comprehensive substance abuse programs will be optional with the States. Programs may be established in those areas that the State determines have particular need for such programs.

B. PROVISIONS RELATING TO AFDC

AFDC Assets Test

Present Law

Under provisions of the Omnibus Budget Reconciliation Act of 1981, a family is ineligible for aid if its resources (reduced by any obligations or debts with respect to such resources) exceed $1,000 or such lower amount as the State may determine. This limit does not include a home owned and occupied by the family,

or the ownership interest in an automobile (up to such limit as the Secretary prescribes in regulations).

Proposed Change

With respect to AFDC recipients, States may, at their option, disregard amounts (not to exceed $8,000) placed in a designated account (including an individual retirement account) or other mechanism approved by the State agency for the purpose of enabling a member of the family to attend a post-secondary education institution or training program. At their option, States may also disregard amounts set aside to enhance employability by other means (such as purchase of an automobile necessary for work), or to purchase a home.

Amounts withdrawn from these accounts for use for approved purposes must be disregarded as income.

Amounts withdrawn and used for any other purpose must be counted as unearned income.

The provision is effective beginning October 1, 1993. The Secretary of HHS is required to conduct a study of the use made of the provision. Any recommendations the Secretary may have with respect to modifications of the provision must be submitted to the Committee on Finance and the Committee on Ways and Means prior to January 1, 1997. No new accounts may be approved after September 30, 1997.

Disregard of Income and Resources Related to Self-Employment

Present Law

There is no provision in the AFDC statute that allows a State to disregard income and resources related to ownership and operation of commercial enterprises.

Proposed Change

In determining a family's eligibility for AFDC, States may, at their option, exclude as a resource the first $10,000 of the net worth (assets reduced by liabilities with respect thereto) of all microenterprises owned in whole or in part by a member of the family.

In addition, they may consider as earned income to the family only the net profits of such microenterprises. The term "net profits" is defined to mean the gross receipts of the business, minus amounts paid as principal or interest on a loan to the microenterprise, transportation expenses, inventory costs, amounts expended to purchase capital equipment, cash retained by the microenterprise for future use by the business, taxes paid by reason of the business, any premiums paid for insurance against

loss and the losses incurred by the business that are not reimbursed by the insurer by reason of a deductible, and the reasonable costs of obtaining one motor vehicle necessary for the conduct of the business.

These special rules for counting income and resources may apply with respect to any microenterprise for a period not to exceed two years.

The term "microenterprise" is defined to mean a commercial enterprise which has five or fewer employees, one or more of whom owns the enterprise.

States that choose this option must ensure that caseworkers are able to properly advise recipients of aid of the option of forming a microenterprise, and will encourage individuals who are interested to participate in a program designed to assist them in such an effort.

Delay in AFDC-UP Mandate for Outlying Jurisdictions

Present Law

The Family Support Act of 1988 required all States to implement the AFDC Unemployed Parent (AFDC-UP) program by October 1, 1990. The requirement for Puerto Rico, Guam, and the Virgin Islands takes effect on October 1, 1992.

Proposed Change

The requirement for implementation of the Unemployed Parent program is delayed until such time as the limitations on Federal matching payments to these jurisdictions for purposes of making AFDC maintenance payments are repealed (section 1108(a) of the Social Security Act).

State Option to Use Retrospective Budgeting Without Monthly Reporting

Present Law

In determining AFDC benefits for recipients, States have the option of using retrospective budgeting under which benefits are based on the family's income and circumstances in a prior month, rather than the current month. However, they may use retrospective budgeting only in cases where families are required to report monthly on their income, resources, and other relevant factors.

Proposed Change

Beginning with fiscal year 1993, States would be allowed to

determine AFDC benefits using retrospective budgeting without regard to whether the family is required to make monthly reports.

C. JOB OPPORTUNITIES AND BASIC SKILLS TRAINING (JOBS) PROGRAM

Temporary Increase in Federal Matching Rate

Present Law

The Family Support Act of 1988 provided for replacement of the Work Incentive (WIN) program with a new Job Opportunities and Basic Skills Training (JOBS) program. The legislation provides Federal matching funds to the States through a capped entitlement mechanism aimed at assuring each State its share of Federal entitlement dollars. The amount of the entitlement is $600 million in 1989, $800 million in 1990, $1 billion in 1991, 1992, and 1993, $1.1 billion in 1994, and $1.3 billion in 1995.

The Federal match for the JOBS program is 90 percent for expenditures up to the amount allotted to the State for the WIN program in fiscal year 1987. For additional amounts, the Federal match is at the Medicaid matching rate, with a minimum Federal match of 60 percent for non-administrative costs and for personnel costs for full-time staff working on the JOBS program. The match for other administrative costs is 50 percent. State matching for amounts above the 1987 WIN allocation must be in cash. States receive an amount equal to their WIN allotment for fiscal year 1987 ($126 million for all States). Additional funds are allocated on the basis of each State's relative number of adult recipients.

Proposed Change

The Federal matching rates on Federal funding above the WIN allocation are increased by 15 percent points in fiscal year 1993, 10 percentage points in 1994, and 5 percentage points in 1995. In addition, the cap on funding for fiscal years 1993 and 1994 is increased by $100 million (to $1.1 billion in 1993 and $1.2 billion in 1994). A maintenance of effort provision would require States to maintain spending at their prior year levels.

Provision Affecting Indian Tribes

Present Law

The Family Support Act of 1988 provides Federal funding for JOBS programs administered by Indian tribes whose applications for funding have been approved by the Secretary of HHS. The formula for funding each program is based on the number of adult members of the Indian tribe that receive AFDC. This formula excludes those Indians who live on the Indian reservation but

belong to another tribe.

Proposed Change

All Indians who live on the reservation, regardless of whether they are members of the tribe, will be counted in determining the tribe's allocation of funds.

Modification of Work Supplementation Program

Present Law

Title IV-F of the Social Security Act provides for two kinds of work programs for AFDC recipients. Under the work supplementation program, a State may reserve the sums that would otherwise be payable to participants in AFDC and use such sums instead for the purpose of providing and subsidizing jobs as an alternative to the AFDC grant. Jobs may be provided to an AFDC recipient either by the AFDC agency or by any other employer. In practice, States have generally used the work supplementation program to subsidize wages of recipients who take jobs with private employers.

Under the Community Work Experience program (CWEP), a State may require an individual to work in a public job in exchange for the welfare grant, with the maximum number of hours that an individual may be required to work limited to the amount of AFDC payable with respect to the individual's family divided by the greater of the Federal minimum wage or the applicable State minimum wage.

Under both programs, recipients may not be assigned to any established unfilled position vacancy.

Proposed Change

Under the work supplementation program, the prohibition against assigning an individual to an unfilled position vacancy is repealed. Assignments to work supplementation positions must be in the private sector.

D. COMMUNITY WORKS PROGRESS DEMONSTRATIONS

A Community Works Progress demonstration program is established under title XI of the Social Security Act. The Secretary of HHS, in consultation with the Secretary of Labor, will administer the program. The Secretary must award grants to 3 urban projects and 2 projects that are Statewide. Demonstrations may last up to 4 years. Entities that will be eligible to apply for grants include both public and private nonprofit organizations.

Approvable projects will include those projects that the Secretary determines will serve a useful public purpose in fields such as health, social service, environmental protection, education, urban and rural development and redevelopment, welfare, recreation, public facilities, public safety, and child care.

For each of fiscal years 1994, 1995, 1996, and 1997, each entity that has an application for a grant approved by the Secretary shall be entitled to payments in an amount equal to its expenditures to carry out the demonstration. The amounts authorized shall be $100 million in each of fiscal years 1994, 1995, 1996, and 1997. No more than 25% of funds may be used for capital costs.

In awarding grants, the Secretary shall consider the following factors: unemployment rate; proportion of population receiving public assistance; per capita income; degree of involvement and commitment demonstrated by public officials; the likelihood that the project will be successful; the contribution that the project is likely to make toward improving the life of residents in the community; geographic distribution; urban-rural distribution; and such other criteria as the Secretary may establish.

Those eligible to participate in projects will include individuals who are receiving AFDC or are at risk of dependency on AFDC; individuals receiving or eligible to receive unemployment compensation; and non-custodial parents of children who are receiving AFDC.

State agencies may refer AFDC recipients who are in the JOBS program to participate in projects under the same rules as apply to the community work experience program (CWEP).

Participants will generally receive (as applicable) an amount equal to: the AFDC grant plus 10%; the unemployment benefit plus 10%; the Federal minimum wage or the applicable State minimum wage, whichever is greater. No individual may participate for more than 32 hours a week.

The Secretary may approve projects that elect to pay wages above the minimum wage for jobs that are designated as requiring special skills or experience. The number of jobs designated as eligible for these additional wages may not exceed 30 percent of all jobs in the project.

Individuals participating in projects will be eligible for assistance to meet necessary costs of transportation and child care, as well as necessary costs of uniforms or other work materials.

Approved demonstrations must ensure that projects will not result in displacement of currently employed workers. There must

also be assurances that there will be consultation with any local labor organization representing employees in the area who are engaged in the same or similar work as that proposed to be carried out by the project.

In approving grants, the Secretary must assure that there will be rigorous evaluation of the projects. Up to 3 percent of the amount granted to each entity may be used for this purpose. Interim reports to the Finance and Ways and Means Committees are due annually, with a final report due four years after the first grant is awarded.

The Secretary must publish the grant application notice no later than January 1, 1993.

E. SOCIAL SECURITY (OASDI)

. Use of Social Security Numbers by State and Local Court Systems for Jury Selection Purposes

Present Law

The Privacy Act of 1974 prohibits States from requiring individuals to provide social security numbers for identification purposes unless the State was doing so prior to January 1, 1975, or unless the State is specifically permitted to do so under Federal law (e.g., for tax administration, drivers license and motor vehicle registration).

Proposed Change

Courts typically use computerized jury source lists within their jurisdiction to select jurors. The proposal would allow them to use the social security numbers of prospective jurors to eliminate duplicate names and the names of convicted felons from the jury source lists.

Repeal of the Facility of Payment Provision

Present Law

The maximum family benefit (MFB) is a limit on the total amount of social security benefits that can be paid to a worker and his or her dependents. As a general rule, if there is cause to reduce the benefit of one dependent member of a family that is subject to the MFB because of excess earnings or some other factor, the amount reduced is redistributed and paid to the other dependent family members. However, if all the dependents are living in the same household, the check of the individual affected by the reduction is not actually reduced or withheld, and no actual redistribution occurs. This procedure, known as the facility of payment provision, was originally intended as an

administrative simplification, but adds complexity and confusion in today's computerized administrative environment.

Proposed Change

The facility of payment provision would be repealed so that a family member's benefit could be reduced when appropriate and benefits redistributed within the MFB to other family members.

Conform Social Security Definition of Disability for Children to the SSI Definition for Children

Present Law

The basic definition of disability, inability to engage in any substantial gainful activity by reason of a physical or mental impairment, is the same under the Social Security Disability Insurance program and the Supplemental Security Income program. In the SSI program, however, the law further provides that children under the age of 18 are considered disabled if they suffer from an impairment of "comparable severity" to one that would prevent an adult from working. The Disability Insurance program has no similar provision applicable to children, although under the program there are certain limited circumstances in which a child must establish disability prior to attaining age 18.

Proposed Change

The proposal would establish a "comparable severity" definition of disability for children under the Disability Insurance program that is identical to the definition in the SSI program.

Increased Penalties for Unauthorized Disclosure of Social Security Information

Present Law

The Social Security Act contains provisions prohibiting the unauthorized disclosure of personal and other information obtained in administering the Act. The Act provides that any person who violates these provisions and makes an unauthorized disclosure can be found guilty of a misdemeanor and, upon conviction, punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both. Under the Act, these penalty provisions are also applicable to anyone who fraudulently attempts to obtain information as to the date of birth, employment, wages, or benefits of another individual.

Proposed Change

The proposal would make unauthorized disclosure of information and fraudulent attempts to obtain personal information under the Social Security Act a felony. Each occurrence of a violation would be punishable by a fine not exceeding $10,000, imprisonment not exceeding 5 years, or both.

Provision Relating to Misuse of Social Security Symbols

Present Law

The misuse of words, letters, symbols and emblems of the Social Security Administration (SSA) and the Health Care Financing Administration (HCFA) is prohibited by law, in order to prevent organizations from conducting mailings or solicitations that might create the false impression among recipients that a product was endorsed, approved or authorized by SSA or HCFA. The Secretary of Health and Human Services is authorized to impose civil monetary penalties for misuse, not to exceed $5,000 per violation or, in the case of a broadcast or telecast, $25,000 per violation. The total amount of penalties that may be imposed on an individual or organization is limited to $100,000 a year.

Proposed Change

The proposal would strengthen the deterrent against mass mailings that use deceptive practices by making each piece of mail a violation, and by eliminating the $100,000 ceiling on annual penalties. It would add the names, letters, symbols, or emblems of the Supplemental Security Income (SSI) program, Medicaid, and the Department of Health and Human Services (HHS) as protected items. It would also add a more inclusive prohibition against the use of the names or symbols that are presented in a manner which "reasonably could be interpreted or construed as conveying" a relationship to SSA, HCFA or HHS.

The Department of Justice would no longer have to issue a formal declination of action before the Secretary could pursue a civil monetary penalty. The Secretary of HHS would be required to report annually to the Congress concerning deceptive practices involving SSA and actions taken against violations.

F. SUPPLEMENTAL SECURITY INCOME

Prevention of Adverse Effects on SSI Eligibility when Spouse or Parent is Absent Due to Military Service

Present Law

If the parent or spouse of family members who receive SSI

payments resides in the household and then is required to be absent from the household because of an active military duty assignment, this absence can cause the family members to lose benefits or eligibility for SSI. This is because absence from the household causes more of the income of the absent member to be attributed to those receiving SSI in the household. Also, if the military duty assignment involves armed conflict, the service member may receive hazardous duty pay. This additional income, if sent back to the household, can also reduce the SSI payments or cause ineligibility of family members.

Proposed Change

The proposal would ensure that service members' absence from their households on active military duty and receipt of hazardous duty pay would not result in a reduction in SSI benefit amounts or a loss of SSI eligibility for their spouses or children at home.

SSI Eligibility for Children of Armed Forces Personnel in Puerto Rico and U. S. Territories

Present Law

SSI benefits are generally continued for children who are U.S. citizens and who accompany their parents on U.S. military assignments to foreign countries. Benefits do not continue if the parents are stationed in Puerto Rico or in the territories or possessions of the United States.

Proposed Change

The proposal would continue SSI benefits to children who are U.S. citizens if they received SSI benefits in the United States and then accompany their parents on U.S. military assignment to Puerto Rico or territories or possessions of the United States.

Definition of Disability for Children under Age 18 Applied to All Individuals under Age 18

Present Law

The SSI law provides a definition of disability applicable to children. The SSI program defines a child as someone who is under age 18, except for individuals under age 18 who are married or are heads of household.

Proposed Change

The proposal would extend the SSI childhood definition of disability to any person under age 18.

Valuation of Certain In-Kind Support and Maintenance When There Is a Cost of Living Adjustment in SSI Benefits

Present Law

Under present law, a person who lives in the household of another person and receives in-kind support and maintenance (ISM) from the householder has his or her SSI benefit reduced by an amount equal to one-third of the full Federal SSI benefit. Regulations provide for a similar reduction when an individual lives in his or her own household and receives in-kind support and maintenance, or lives in another person's household and receives food or shelter, but not both.

Under the two-month retrospective accounting system that generally governs SSI benefit calculations, the values of the deductions for receipt of ISM are determined using the Federal SSI benefit level that was in effect two months prior to the current month. As a result, when a cost of living adjustment (COLA) increases the Federal benefit level and an individual's benefit payment each January, the amount deducted because of ISM from the individual's January and February benefits remains based on the lower Federal benefit level for November and December. In March, when retrospective accounting causes the deduction for ISM to be recalculated and increased based on the higher January Federal benefit standard, the individual's benefit is then decreased. This is confusing for SSI recipients, whose benefits are increased in January and February due to the COLA, then are decreased beginning in March due to retrospective accounting for ISM.

Proposed Change

The proposal would require the use of the Federal benefit level for the current month in determining the value of ISM to be used in calculating an individual's SSI payment for that month. This would ensure that benefits beginning in January contain the proper COLA increase and would eliminate the benefit reduction for ISM that now occurs in March.

Elimination of Obsolete Provisions Relating to Treatment of the Earned Income Tax Credit

Present Law

Beginning in 1991, the Earned Income Tax Credit (EITC) was excluded from the tests of income and resources under the SSI program by the Omnibus Budget Reconciliation Act of 1990. However, provisions of Title XVI of the Social Security Act, which authorizes the SSI program, were not changed to conform.

Proposed Change

The change would delete provisions of Title XVI that define EITCs as earned income for SSI purposes, and that provide for adjustment to SSI benefits for individuals who receive advance payment of EITCs.

G. OTHER INCOME SECURITY PROVISIONS

Measurement and Reporting of Welfare Dependency

Present Law

Currently there is no mechanism to collect statistical data that can be used to assess welfare dependency in the United States.

Proposed Change

The Secretary of Health and Human Services is required to develop indicators and rates related to the level of welfare dependency in the United States, and predictors that are correlated with welfare dependency. In addition, the Secretary must assess the data needed to report annually on these indicators, rates, and predictors, including the ability of existing data collection efforts to provide such data, and any additional data that needs to be collected.

Not later than two years after the date of enactment, the Secretary must provide an interim report with conclusions resulting from the development and assessment described above to designated Committees of Congress.

An Advisory Board on Welfare Dependency will be created, composed of 12 members with equal numbers appointed by the House of Representatives, the Senate, and the President. The Board will be composed of experts in the fields of welfare research and statistical methodology, representatives of State and local welfare agencies, and organizations concerned with welfare issues. The Board will provide advice and recommendations to the Secretary on the development of indicators, rates, and predictors of welfare dependence, and the identification of data collection needs and existing data collection efforts. It will also provide advice on the development and presentation of the annual welfare dependency report.

The Secretary will be required to prepare an annual report on welfare dependency that attempts to identify indicators, rates, and predictors of welfare dependency and trends in dependency, and provide information and analysis on the causes of dependency. The first report is due not later than 3 years after the date of enactment.

Extend National Commission on Children

Present Law

The National Commission on Children was established in 1987 as a bipartisan commission to develop recommendations for public and private sector policies to improve opportunities for children and youths to become healthy, secure, educated, economically self-sufficient, and productive adults. Its final report, "Beyond Rhetoric: A New American Agenda for Children and Families," was issued on June 24, 1991. The Commission is still in the process of developing information to inform the public about the status of children and on proposals to address their needs through public and private sector programs.

Proposed Change

The proposal would allow the Commission to complete its work by extending the terms of the members to December 31, 1992, and by providing Commission staff until March 31, 1993 to close down the Commission's operations. It also eliminates a conflict in provisions of OBRA 90 regarding an interim reporting date for the Commission by specifying the correct date in 1990.

Require Study of Program Coordination

Present Law

Although the AFDC, food stamp, and medicaid programs all serve low income families, the eligibility rules and procedures for these programs vary significantly.

Proposed Change

The Secretary of HHS and the Secretary of Agriculture are required to report jointly to the President and the Congress on (1) program rules which govern the AFDC, food stamp, and medicaid programs; (2) how the program rules differ; (3) which rules require statutory action in order to achieve uniformity; and (4) which rules could be made uniform without statutory change.

The rules to be included in the report must include all rules related to administrative procedures, resources, definitions of countable income, and definitions of income disregards and exemptions. Income eligibility rules are not to be included.

Declaration of Citizen and Alien Status

Present Law

Section 1137(d) of the Social Security Act specifies that States must require, as a condition of eligibility for the AFDC, medicaid, unemployment compensation, and food stamp programs, a declaration in writing by each adult individual (or, in the case of a child, by another individual on the child's behalf), stating whether the individual is a citizen or national of the U. S., and if not, that the individual is in a satisfactory immigration status.

Proposed Change

The statute would be amended to allow one adult member of a family or household to sign a declaration on behalf of other adults in the household. In addition, in the case of a newborn child, an adult would be permitted to sign a declaration on behalf of the child no later than the next redetermination of the eligibility of the family or household.

Exclusion of Income Received by Indians from Interests Individually Held in Trust or Restricted Lands

Present Law

Under present law, up to $2,000 of annual income received by an Indian from tribally-owned trust lands is exempted from consideration under SSI, AFDC, and other Federal welfare programs. This income is distributed on a per capita basis to tribal members, but the land which produces the income is owned by the tribe as a whole and managed by the Bureau of Indian Affairs. The value of individually-owned trust or restricted Indian lands is excluded from resources under the SSI and AFDC programs, but income paid to the Indian owner from leases of these lands is counted as income.

Proposed Change

In determining eligibility and benefit levels under the SSI and AFDC programs, up to $4,000 per year of income paid to an Indian would be exempted when that income is derived from leases of individually-owned trust or restricted Indian lands.

Extension of Demonstration to Expand Job Opportunities

Present Law

The Family Support Act of 1988 established a demonstration

project under which not less than 5 nor more than 10 nonprofit organizations were authorized to conduct demonstration projects to create employment opportunities for certain low-income individuals. The amount authorized for these grants is $6.5 million for each of fiscal years 1990, 1991, and 1992.

Proposed Change

The demonstration project would be continued for 2 additional years. Prior to January 1, 1994, the Secretary must issue a final report to the Congress, including an evaluation of the projects and any recommendation the Secretary determines to be appropriate.

Disclosure of Information to Railroad Retirement Board

Present Law

The Railroad Unemployment Repayment Tax requires railroad employers to repay loans made from the Railroad Retirement Account to the Railroad Unemployment Insurance Account. The Railroad Retirement Board (RRB) does not have access to tax return information filed under the Railroad Unemployment Repayment Tax provision.

Proposed Change

The proposal would amend the Internal Revenue Code to allow the RRB to obtain Railroad Unemployment Repayment Tax information needed to assure and verify proper repayment of the loans.

Income Security Technical Corrections

Redesignation of Certain SSI Provisions

Explanation of Provision

Two subparagraphs of the Social Security Act dealing with SSI are erroneously designated. The change would correct the erroneous designation.

Technical Corrections Related to OASDI in the Omnibus Budget Reconciliation Act of 1990

Explanation of Provision

The provision: (a) corrects two references to the definition of disability for widows in the Social Security Act to bring them into conformance with the provisions of the Omnibus Budget Act of 1990 (OBRA 90); (b) redesignates provisions of the Social Security Act related to representative payees to conform with provisions of OBRA 90; (c) clarifies the provision of OBRA 90 that establishes streamlined procedures for approval of fees for representatives of claimants for title II (social security) and title XVI (SSI) benefits; (d) eliminates a technical error in the language of the OBRA 90 provision eliminating advance tax transfers to the social security trust funds.

Corrections Related to the Income Security and Human Resources Provisions of the Omnibus Budget Reconciliation Act of 1990

Explanation of Provision

The provision makes several technical and conforming changes related to provisions enacted under OBRA 90 affecting designations of sections of law and appropriate cross references under Title XVI of the Social Security Act, and deletes a clause of Title XVI concerning representative payees that was inadvertently retained when a comparable provision in Title II was deleted by OBRA 90.

III. SAVINGS INCENTIVES:

Individual Retirement Arrangements (IRAs)

Present Law

Under present law, certain individuals are allowed to deduct contributions (up to the lesser of $2,000 or 100 percent of the individual's compensation or earned income) to an individual retirement arrangement (IRA). The amounts held in an IRA, including earnings on contributions, generally are not included in taxable income until withdrawn.

The $2,000 deduction limit is phased out over certain adjusted gross income (AGI) levels ($25,000 for individuals, $40,000 for joint filers) if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan. An individual may make nondeductible IRA contributions (up to the $2,000 or 100 percent of compensation limit) to the extent the individual is not permitted to make deductible IRA contributions.

Description of Proposal

Deductible IRAs

The proposal would restore the deductibility of IRA contributions for all taxpayers under the rules in effect prior to the Tax Reform Act of 1986, and would provide for the indexing of the limits on contributions to IRAs, in increments of $500.

Special IRAs

In addition, the proposal would permit nondeductible contributions to new special IRAs. Withdrawals from a special IRA would not be includible in income if attributable to contributions that had been held by the special IRA for at least 5 years. The limits on contributions to deductible IRAs and special IRAs would be coordinated. Furthermore, the limit on contributions to deductible IRAs and special IRAs would be coordinated with the limit on elective deferrals to a qualified cash or deferred arrangement (sec. 401(k) plan), tax-sheltered annuity (sec. 403(b) annuity), simplified employee pension (SEP), or a section 501(c)(18) plan. Thus, for example, in no case could the sum of contributions (deductible and nondeductible) to an IRA, contributions to a special IRA, and elective contributions to a 401(k) plan exceed the limit on elective deferrals ($8,728 in 1992).

The proposal would permit transfers from deductible IRAs to special IRAs without imposition of the 10-percent tax on early withdrawals. The amount transferred to a special IRA generally would be includible in income in the year

withdrawn. However, in the case of a transfer before January 1, 1994, the transferred amount would be includible in income ratably over a 4-taxable year period.

Penalty-free withdrawals from IRAs

The proposal would allow withdrawals from an IRA and from amounts attributable to elective deferrals under (1) a section 401(k) plan, (2) a tax-sheltered annuity (sec. 403(b) annuity), or (3) a section 501(c)(18) plan without imposition of the 10-percent additional income tax on early withdrawals to the extent the amount withdrawn is used to pay qualified acquisition, construction, or reconstruction costs with respect to a principal residence of a first-time homebuyer who is the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild. A first-time homebuyer would be defined as any individual (and if married, such individual's spouse) who had no present interest in a principal residence during the 2-year period prior to the purchase of a home. In addition, the proposal would provide that, in the case of certain homebuyers whose family incomes do not exceed $15,000, ownership of land subject to certain contracts for deed does not violate the requirement regarding first-time home ownership. A similar rule would apply to the definition of first-time home purchase with respect to the first-time homebuyer credit.

The waiver of the 10-percent additional tax on early withdrawals would also apply to the extent distributions did not exceed qualified higher education expenses. Qualified higher educational expenses means tuition, fees, books, supplies, and equipment required for the enrollment of or attendance of the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild at a college, university, or post-secondary vocational school. The amount of qualified higher educational expenses for any taxable year would be reduced by any amount excludable from gross income under the proposal in the Code pertaining to U.S. education savings bonds.

The proposal would extend to IRAs the present-law exception to the 10-percent additional income tax for distributions from qualified retirement plans used to pay deductible medical expenses. For purposes of the medical expense exception (with regard to both IRAs and qualified retirement plans), a child, grandchild, or ancestor of the taxpayer would be treated as a dependent of the taxpayer in determining whether medical expenses are deductible.

The proposal would also permit penalty-free withdrawals for the long-term unemployed.

Finally, the proposal would provide that the present-law rule permitting penalty-free IRA withdrawals after an individual reaches 59-1/2 would not apply in the case of amounts attributable to contributions made during the previous 5 years. Thus, IRA contributions generally would have to remain in the account for at least 5 years to avoid withdrawal penalties. This restriction would only apply to contributions (and earning allocated thereto) that are made after December 31, 1992. Moreover, for purposes of applying the rule, distributions would be treated as having been made first from the earliest contributions (and earnings) remaining in the account, and then from other contributions in the order in which made.

Effective Date

The proposal generally would apply to taxable years beginning after December 31, 1993. However, the rule permitting penalty-free withdrawals in certain cases would be effective for taxable years beginning after December 31, 1992. In addition, the rule permitting transfers from deductible IRAs to special IRAs would be effective for taxable years beginning after December 31, 1992. Thus, special IRAs could be established and maintained in taxable years beginning before January 1, 1994, only with funds transferred from a deductible IRA.

IV. OTHER ECONOMIC DEVELOPMENT PROVISIONS

A. Special Depreciation Allowance for Certain Equipment Acquired in 1992

Present Law

Depreciation deductions

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the accelerated cost recovery system (ACRS), as modified by the Tax Reform Act of 1986. Under ACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

For purposes of the alternative minimum tax (AMT), tangible personal property generally is depreciated using the 150-percent declining balance method over useful lives that are typically longer than the applicable recovery periods for regular tax purposes. In addition, for purposes of the adjusted current earnings (ACE) component of the corporate AMT, tangible personal property is depreciated using the straight-line method over these longer useful lives.

Expensing election

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $10,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $10,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Description of Proposal

The proposal would allow an additional first-year depreciation deduction equal to 15 percent of the adjusted basis of certain qualified property that is placed in service before July 1, 1993. The additional depreciation deduction would be allowed for both regular tax and AMT purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year of purchase and later years would be appropriately adjusted to reflect the additional first-year depreciation deduction. A taxpayer would be allowed to elect to not claim the additional first-year depreciation for qualified property.

Property would qualify for the additional first-year depreciation deduction if (1) the property is section 1245 property to which ACRS applies (other than property that is required to be depreciated under the alternative depreciation system of ACRS) and (2) the original use of the property commences with the taxpayer on or after August 1, 1992. In addition, the property would be required to be acquired by the taxpayer (1) on or after August 1, 1992, and before January 1, 1993, but only if no binding written contract for the acquisition is in effect before August 1, 1992, or (2) pursuant to a binding written contract which was entered into on or after August 1, 1992, and before January 1, 1993. Finally, property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer will qualify if the taxpayer begins the manufacture, construction, or production of the property on or after August 1, 1992, and before January 1, 1993 (and all other requirements are met).

The limitations on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F of the Code) would be adjusted to reflect the additional first year depreciation deduction. Thus, the limitation on the amount of depreciation allowable for the first year that a passenger automobile to which this proposal would apply would be increased by 15 percent and subsequent year depreciation allowances would be decreased to reflect this first year increase.

Effective Date

The proposal would apply to property placed in service on or after August 1, 1992.

B. Corporate Alternative Minimum Tax: Elimination of ACE Depreciation Adjustment for Corporate AMT

Present Law

Under present law, a corporation is subject to an alternative minimum tax ("AMT") which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. Alternative minimum taxable income ("AMTI") is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items. For a corporation, the amount of AMT paid in a year may be carried forward as a credit and used to reduce the corporation's regular tax liability (but not below the corporation's tentative minimum tax for the year).

One of the adjustments that is made to taxable income to arrive at AMTI relates to depreciation. Depreciation on most personal property to which the modified ACRS system adopted in 1986 applies is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the life described in Code section 168(g) (generally the ADR class life of the property).

For taxable years beginning after 1989, AMTI is increased by an amount equal to 75 percent of the amount by which adjusted current earnings ("ACE") exceeds AMTI (as determined before this adjustment). The ACE adjustment replaced the book-income adjustment applicable to tax years 1987 through 1989. In general, ACE equals AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. For purposes of ACE, depreciation is computed using the straight-line method over the class life of the property. Thus, a corporation generally must make two depreciation calculations for purposes of the AMT--once using the 150-percent declining balance method and again using the straight-line method.

Description of Proposal

The proposal would eliminate the depreciation component of ACE for corporate AMT purposes. Thus, in computing ACE, a corporation would use the same depreciation methods and lives that it uses in computing AMTI (generally, the 150-percent declining balance method for tangible personal property).

Effective Date

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

C. Tax Credit for First-Time Homebuyers

Present Law

There is no tax credit for the purchase of a principal residence under present law.

Description of Proposal

Under the proposal, individuals who purchase a principal residence would be eligible to receive a tax credit equal to 10 percent of the purchase price of the residence, up to a maximum credit of $2,500. The credit would apply to a principal residence if the taxpayer (1) acquires such residence on or after July 28, 1992, and before January 1, 1993, or (2) enters into a binding contract to acquire the residence on or after July 28, 1992, and before January 1, 1993, and purchases the residence within 90 days of entering into that binding contract. One-half of the credit would be allowed in the taxable year in which the purchase occured and the other half would be allowed in the following taxable year. Only one tax credit could be claimed per residence.

First-time homebuyers would be defined as individuals who did not have a present interest in a residence in the 3 years preceding the purchase of a home. If an individual is deferring tax on gain from the sale of a previous principal residence and is permitted an extended rollover period, he or she would not be considered a first-time homebuyer until after the end of the extended rollover period.

The first-time homebuyer credit would be nonrefundable, and thus would be available only to the extent the taxpayer had income tax liability to offset. However, any unused portion of the credit could be carried forward for up to 5 years and applied against future income tax liability.

The credit would be recaptured if the residence on which the credit was claimed was sold or otherwise disposed of within 3 years of the date the residence was purchased. The recapture rule would not apply, however, to dispositions by reason of the taxpayer's death or divorce. If the taxpayer sold the residence within 3 years but purchased a new home within the rollover period, the credit would be recaptured to the extent the taxpayer would have claimed a smaller credit on the new residence had it been purchased during the period when the credit was available.

Effective Date

The proposal would be effective for purchases on or after July 28, 1992.

D. Changes Relating to Real Estate Investments by Pension Funds and Others

1. Modification of the rules related to debt-finance income

Present Law

In general, a qualified pension trust or an organization that is otherwise exempt from Federal income tax is taxed on any income from a trade or business that is unrelated to the organization's exempt purposes (Unrelated Business Taxable Income or "UBTI") (sec. 511). Certain types of income, including rents, royalties, dividends, and interest are excluded from UBTI, except when such income is derived from "debt-financed property." Income from debt-financed property generally is treated as UBTI in proportion to the amount of debt financing (sec. 514(a)).

An exception to the rule treating income from debt-financed property as UBTI is available to pension trusts, educational institutions, and certain other exempt organizations (collectively referred to as "qualified organizations") that make debt-financed investments in real property (sec. 514(c)(9)(A)). Under this exception, income from investments in real property is not treated as income from debt-financed property. Mortgages are not considered real property for purposes of the exception.

The real property exception to the debt-financed property rules is available for investments in debt-financed property, only if the following six restrictions are satisfied: (1) the purchase price of the real property is a fixed amount determined as of the date of the acquisition (the "fixed price restriction"); (2) the amount of the indebtedness or any amount payable with respect to the indebtedness, or the time for making any payment of any such amount, is not dependent (in whole or in part) upon revenues, income, or profits derived from the property (the "participating loan restriction"); (3) the property is not leased by the qualified organization to the seller or to a person related to the seller (the "leaseback restriction"); (4) in the case of a pension trust, the seller or lessee of the property is not a disqualified person (the "disqualified person restriction"); (5) the seller or a person related to the seller (or a person related to the plan with respect to which a pension trust was formed) is not providing financing in connection with the acquisition of the property (the "seller-financing restriction"); and (6) if the investment in the property is held through a partnership, certain additional requirements are satisfied by the partnership (the "partnership restrictions") (sec. 514(c)(9)(B)(i) through (vi)).

Description of Proposal

Relaxation of the leaseback and disqualified person restrictions

The proposal relaxes the leaseback and disqualified person restrictions to permit a limited leaseback of debt-financed real property to the seller (or a person related to the seller) or to a disqualified person.[1] The exception applies only where (1) no more than 25 percent of the leasable floor space in a building is leased back to the seller (or related party) or to the disqualified person, and (2) the lease is on commercially reasonable terms.

Relaxation of the seller-financing restriction

The proposal relaxes the seller-financing restriction to permit seller financing on terms that are commercially reasonable. The proposal grants authority to the Treasury Department to issue regulations for the purpose of determining commercially reasonable financing terms.

The proposal does not modify the present-law fixed price and participating loan restrictions. Thus, for example, income from real property acquired with financing where the timing or amount of payment is based on revenue, income, or profits from the property generally will continue to be treated as income from debt-financed property, unless some other exception applies.

Relaxation of the fixed price and participating loan restriction for property foreclosed on by financial institutions

The proposal relaxes the fixed price and participating loan restrictions for certain sales of real property foreclosed upon by financial institutions.[2] The relaxation of these rules is limited to cases where: (1) a qualified organization acquires the property from a financial institution that acquired the real property by foreclosure (or after an actual or imminent default), or was held by the

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[1] As under present law, a leaseback to a disqualified person remains subject to the prohibited transaction rules set forth in section 4975.

[2] For this purpose, financial institutions include financial institutions in conservatorship or receivership and certain affiliates of financial institutions (and a government corporation which succeeded to the rights and interests of such a receiver or conservator).

financial institution at the time that it entered into conservatorship or receivership; (2) the property is not a capital asset of the financial institution; (3) the stated principal amount of the seller financing does not exceed the financial institution's outstanding indebtedness (including accrued but unpaid interest) with respect to the property at the time of foreclosure; and (4) the value of any participation feature at the time of sale does not exceed 30 percent of the value of the property.

The proposal grants authority to the Treasury Department to issue regulations for the purpose of clarifying these limitations. In particular, these regulations are expected to establish standards for determining what constitutes a participation feature and how to determine whether the value of a participation feature at the time of sale exceeds 30 percent of the value of the property. For example, a participation feature that provides the seller with less than a 30 percent interest in net proceeds, net income, or gain on sale of the property is expected to be valued at less than 30 percent of the value of the property.

Elimination of the section 514(c)(9)(B) restrictions for investments through certain large partnerships

The proposal eliminates the six section 514(c)(9)(B) restrictions for qualified organizations that invest in real property through certain "large" partnerships.

A "large" partnership is a partnership having at least 250 partners that satisfies the following three tests: (1) interests in the partnership are registered with the Securities and Exchange Commission; (2) a significant percentage (at least 50 percent) of each class of interests is owned by taxable individuals (but excluding IRAs from the calculation); and (3) a principal purpose of the partnership allocations is not tax avoidance. Partnership interests that are subject to the same terms are considered to be in the same class, regardless of whether the interests are subject to different ownership restrictions (a partnership can therefore monitor the 50-percent ownership restriction by requiring that designated interests be held only by taxable persons).

Effective Date

The proposal generally is effective for acquisitions on or after July 28, 1992. The leaseback provision is also effective for leases entered into on or after July 28, 1992.

2. Repeal of the automatic UBTI rule for publicly-traded partnerships

Present Law

In general, the character of a partner's distributive share of partnership income is the same as if the income had been directly realized by the partner. Thus, whether a tax-exempt organization's share of income from a partnership (other than from a publicly-traded partnership) is treated as unrelated business income depends on the underlying character of the income (sec. 512(c)(1)).

However, a tax-exempt organization's distributive share of gross income from a publicly-traded partnership (that is not otherwise treated as a corporation) automatically is treated as UBTI (sec. 512(c)(2)(A)). The organization's share of the partnership deductions is allowed in computing the organization's taxable unrelated business income (sec. 512(c)(2)(B)).

Description of Proposal

The proposal repeals the rule that automatically treats income from publicly-traded partnerships as UBTI. Thus, under the provision, investments in publicly-traded partnerships are treated the same as investments in other partnerships for purposes of the UBTI rules.

Effective Date

The proposal is effective for partnership years ending on or after July 28, 1992.

3. Permit title-holding companies to receive small amounts of UBTI

Present Law

Section 501(c)(2) provides tax-exempt status to certain corporations organized for the exclusive purpose of holding title to property and turning over any income from the property to one or more related tax-exempt organizations. Section 501(c)(25) provides tax-exempt status to certain corporations and trusts that are organized for the exclusive purposes of acquiring and holding title to real property, collecting income from such property, and remitting the income therefrom to no more than 35 shareholders or beneficiaries that are: (1) qualified pension, profit-sharing, or stock bonus plans (sec. 401(a)); (2) governmental pension plans (sec. 414(d)); (3) the United States, a State or political subdivision, or governmental agencies or instrumentalities; or (4) tax-exempt charitable,

educational, religious, or other organizations described in section 501(c)(3). However, the IRS has taken the position that a title-holding company described in section 501(c)(2) or 501(c)(25) will lose its tax-exempt status if it generates any amount of UBTI.[3]

Description of Proposal

The proposal permits a title-holding company that is exempt from tax under sections 501(c)(2) or 501(c)(25) to receive UBTI up to 10 percent of its gross income for the taxable year, provided that the UBTI is incidentally derived from the holding of real property. For example, income generated from parking or operating vending machines located on real property owned by a title-holding company generally would qualify for the 10-percent de minimis rule, while income derived from an activity that is not incidental to the holding of real property (e.g., manufacturing) would not qualify. In cases where unrelated income is incidentally derived from the holding of real property, receipt by a title-holding company of such income (up to the 10-percent limit) will not jeopardize the title-holding company's tax-exempt status, but nonetheless, will be subject to tax as UBTI.

In addition, the proposal provides that a section 501(c)(2) or 501(c)(25) title-holding company will not lose its tax-exempt status if UBTI that is incidentally derived from the holding of real property exceeds the 10-percent limitation, provided that the title-holding company establishes to the satisfaction of the Secretary of the Treasury that the receipt of UBTI in excess of the 10-percent limitation was inadvertent and reasonable steps are being taken to correct the circumstances giving rise to such excess UBTI.

Effective Date

The proposal is effective for taxable years beginning after December 31, 1991.

4. Exclusion from UBTI any gains from the disposition of property acquired from financial institutions in conservatorships or receiverships

Present Law

In general, gains or losses from the sale, exchange or other disposition of property are excluded from UBTI (sec.

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[3] IRS Notice 88-121, 1988-2 C.B. 457. See also Treas. Reg. sec. 1.501(c)(2)-1(a).

512(b)(5)). However, gains or losses from the sale, exchange or other disposition of property held primarily for sale to customers in the ordinary course of a trade or business are not excluded from UBTI (the "dealer UBTI rule") (sec. 512(b)(5)(B)).

Description of Proposal

The proposal provides an exception to the dealer UBTI rule by excluding gains from the sale, exchange or other disposition of certain real property and mortgages acquired from financial institutions that are in conservatorship or receivership (or from a government corporation which succeeded to the rights and interests of such a receiver or conservator). Only real property and mortgages owned by a financial institution (or that was security for a loan extended by the financial institution) at the time that the institution entered conservatorship or receivership are eligible for the exception.

The exclusion is limited to properties designated as disposal property within nine months of acquisition, and disposed of within two-and-a-half years of acquisition. The two-and-a-half year disposition period may be extended by the Secretary if an extension is necessary for the orderly liquidation of the property. No more than one-half by value of properties acquired in a single transaction may be designated as disposal property.

The exclusion is not available for properties that are developed in any significant manner (i.e., the aggregate expenditures made by the acquiror which are includible in the basis of the property do not exceed 20 percent of the net selling price of the property). Thus, for example, the exclusion is not available for property where there has been securing of zoning permits, unless the aggregate expenditures on development do not exceed 20 percent of the net selling price of the property.

Effective Date

The proposal is effective for property acquired on or after July 28, 1992.

5. Exclusion of loan commitment fees and certain option premiums from UBTI

Present Law

Income from a trade or business that is unrelated to an exempt organization's purpose generally is UBTI. Passive income such as dividends, interest, royalties, and gains or losses from the sale, exchange or other disposition of property generally is excluded from UBTI (sec. 512(b)). In

addition, gains on the lapse or termination of options on securities are explicitly exempted from UBTI (sec. 512(b)(5).

Present law is unclear on whether loan commitment fees and premiums from unexercised options on real estate are UBTI.

Description of Proposal

The proposal provides that loan commitment fees and premiums from unexercised options on real estate are excluded from UBTI. For purposes of this provision, loan commitment fees are non-refundable charges made by a lender to reserve a sum of money with fixed terms for a specified period of time. These charges are to compensate the lender for the risk inherent in committing to make the loan (e.g., for the lender's exposure to interest rate changes and for potential lost opportunities).

Effective Date

The proposal is effective for premiums or loan commitment fees that are received on or after July 28, 1992.

6. Relaxation of limitations on investments in real estate investment trusts by pension funds

Present Law

A real estate investment trust ("REIT") is not taxed on income distributed to shareholders. A corporation does not qualify as a REIT if at any time during the last half of its taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by five or fewer individuals ("the five or fewer rule"). A domestic pension trust is treated as a single individual for purposes of this rule.

Dividends paid by a REIT are not UBTI,[4] unless the stock in the REIT is debt-financed. Depending on its character, income earned by a partnership may be UBTI (sec. 512(c)). Special rules treat debt-financed income earned by a partnership as UBTI (sec. 514(c)(9)(B)(vi)).

Description of Proposal

Qualification as a REIT

The proposal provides that a pension trust generally is not treated as a single individual for purposes of the

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[4] See Rev. Rul. 66-151, 1966-1 C.B. 151.

five-or-fewer rule. Rather, the proposal treats beneficiaries of the pension trust as holding stock in the REIT in proportion to their actuarial interests in the trust. This rule does not apply if disqualified persons, within the meaning of section 4975(e)(2) (other than by reason of subparagraphs (B) and (I)), together own five percent or more of the value of the REIT stock and the REIT has earnings and profits attributable to a period during which it did not qualify as a REIT.[5]

In addition, the proposal provides that a REIT cannot be a personal holding company and, therefore, is not subject to the personal holding company tax on its undistributed income.

__Unrelated business taxable income__

Under the proposal, certain pension trusts owning more than 10 percent of a REIT must treat a percentage of dividends from the REIT as UBTI. This percentage is the gross income derived from an unrelated trade or business (determined as if the REIT were a pension trust) divided by the gross income of the REIT for the year in which the dividends are paid. Dividends are not treated as UBTI, however, unless this percentage is at least five percent.

The UBTI rule applies only if the REIT qualifies as a REIT by reason of the above modification of the five or fewer rule. Moreover, the UBTI rule applies only if (1) one pension trust owns more than 25 percent of the value of the REIT, or (2) a group of pension trusts individually holding more than 10 percent of the value of the REIT collectively own more than 50 percent of the value of the REIT.

__Effective Date__

The proposal applies to taxable years beginning after December 31, 1991.

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[5] Moreover, as under present law, any investment by a pension trust must be in accordance with the fiduciary rules of the Employee Retirement Security Act ("ERISA") and the prohibited transaction rules of the Code and ERISA.

E. Modification of Passive Loss Rules for Certain Real Estate Persons

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. Credits from passive activities may not reduce the taxpayer's tax liability, to the extent such credits exceed regular tax liability from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.

The passive loss rules apply to individuals, estates and trusts, closely held C corporations, and personal service corporations. A special rule permits closely held C corporations to apply passive activity losses and credits against active business income (or tax liability allocable thereto) but not against portfolio income.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. To materially participate in an activity, a taxpayer must be involved in the operations of the activity on a regular, continuous, and substantial basis. Except as provided in regulations, a taxpayer is treated as not materially participating in an activity held through a limited partnership interest.

Rental activities (including rental real estate activities) are also treated as passive activities, regardless of the level of the taxpayer's participation. In general, rental activities cannot be treated as part of a larger activity that includes nonrental activities. A special rule permits the deduction of up to $25,000 of losses from rental real estate activities (even though they are considered passive), if the taxpayer actively participates in them. This $25,000 amount is allowed for taxpayers with adjusted gross incomes of $100,000 or less, and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000. Active participation is a lesser standard of involvement than material participation. A taxpayer is treated as actively participating if, for example, he participates, in a significant and bona fide sense, in the making of management decisions or arranging for others to provide services (such as repairs). The active

participation standard is not satisfied, however, if the taxpayer's interest is less than 10 percent (by value) of all interests in the activity. A taxpayer generally is deemed not to satisfy the active participation standard with respect to property he holds through a limited partnership interest.

If the taxpayer has suspended losses from a former passive activity (an activity that is not a passive activity for the current taxable year but was a passive activity for the taxable year in which the loss arose), the losses are offset against the income from such activity for the taxable year, and any excess after the offset continues to be treated as a loss from a passive activity.

Description of Proposal

If the taxpayer meets eligibility requirements with respect to real property trades or businesses in which he performs services, then a portion of the taxpayer's passive activity loss that does not exceed net losses from rental real estate activities in which the taxpayer materially participates generally is allowed under the proposal. Whether a taxpayer materially participates in his rental real estate activities is determined as if each interest of the taxpayer in rental real estate is a separate activity, unless the taxpayer elects to treat all interests in rental real estate as one activity. The provision applies to individuals and closely held C corporations.

The loss allowed under the proposal may not exceed 100 percent of the lesser of (1) the taxpayer's net income from real property trades or businesses, or (2) the taxpayer's taxable income (determined without regard to this proposal). A similar rule applies with respect to passive activity credits.

Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

An individual taxpayer meets the eligibility requirements if more than half of the personal services the taxpayer performs in a trade or business are in real property trades or businesses in which he materially participates. In the case of a joint return, for purposes of the eligibility requirements each spouse's personal services are taken into account separately. For purposes of the eligibility requirements, personal services performed as an employee are not treated as performed in a real estate trade or business unless the person performing services has more than a 5 percent ownership interest in the employer (within the meaning of sec. 416(i)(1)(B)).

A closely held C corporation meets the eligibility requirements if generally more than 50 percent of its gross receipts for the taxable year are derived from real property trades or businesses in which the corporation materially participates (within the meaning of sec. 469(h)(4)).

Material participation has the same meaning as under present law. Thus, as under present law, except as provided in regulations, no interest as a limited partner in a limited partnership is treated as an interest with respect to which the taxpayer materially participates.

Suspended losses from any rental real property activity with respect to which losses are allowed under the provision are limited to income from the activity, and are not allowed to offset other non-passive income.

Modified adjusted gross income is determined without regard to any loss allowable by reason of the proposal, for purposes of the present-law $25,000 allowance of losses and deduction-equivalent credits from certain rental activities.

Effective Date

The proposal is effective with respect to taxable years beginning after December 31, 1991.

F. Treatment of certain real property business indebtedness of individuals

Present Law

The discharge of indebtedness generally gives rise to gross income to the debtor taxpayer. Present law provides exceptions to this general rule. Among the exceptions are rules providing that income from the discharge of indebtedness of the taxpayer is excluded from income if the discharge occurs in a title 11 case, the discharge occurs when the taxpayer is insolvent, or in the case of certain farm indebtedness. The amount excluded from income under these exceptions is applied to reduce tax attributes of the taxpayer.

Description of Proposal

The proposal provides an exclusion from gross income for certain income from discharge of qualified real property business indebtedness of individuals. The amount so excluded is applied as a reduction in basis of depreciable real property of the taxpayer. When the taxpayer disposes of such depreciable real property, the amount of any gain not exceeding the amount of the basis reduction is treated as ordinary income. The amount of the exclusion may not exceed the lesser of (1) the aggregate adjusted basis of the taxpayer's depreciable real property as of the beginning of the taxable year following the year in which the discharge occurs, and (2) the amount by which the outstanding debt (principal and accrued interest) exceeds the fair market of the property at the time of the discharge.

Qualified real property business indebtedness means debt incurred or assumed by an electing individual in connection with real property used by the taxpayer in his trade or business (not including farm debt).

Effective Date

The proposal is effective with respect to discharges after December 31, 1991 in taxable years ending after that date.

G. Increase Recovery Period for Depreciation of Nonresidential Real Property

Present Law

A taxpayer is allowed to recover, through annual depreciation allowances, the cost or other basis of real property (other than land) that is used in a trade or business or that is held for the production of rental income. For regular tax purposes, the amount of the depreciation deduction allowed with respect to nonresidential real property for any taxable year is determined using the straight-line method and a recovery period of 31.5 years.

Description of Proposal

For regular tax purposes, the depreciation deduction for nonresidential real property would be determined by using a recovery period of 40 years.

Effective Date

The proposal generally would apply to property placed in service on or after July 28, 1992. The proposal would not apply to property that is placed in service by a taxpayer before January 1, 1995, if (1) the taxpayer or a qualified person entered into a binding written contract to purchase or construct the property before July 28, 1992, or (2) construction of the property was commenced by or for the taxpayer or a qualified person before July 28, 1992.

V. ECONOMIC DEVELOPMENT PROVISIONS OF H.R. 3040 (TAX EXTENSION ACT OF 1992) AS REPORTED BY FINANCE COMMITTEE

The Chairman's Mark includes the provisions of H.R. 3040 (Tax Extension Act of 1992) as reported by the Senate Finance Committee[1] with the following modifications.

A. Low-Income Housing Tax Credit

The proposal would include the following modifications to the extension of the low-income housing tax credit ("LIHC") program, as passed by the Senate in H.R. 3040:

(1) The proposal allows an irrevocable election by the owner of building placed-in-service before 1990 to use either apartment size or family size in determining maximum allowable rent only if the owner enters into a compliance monitoring agreement with the State allocating agency. This election must be made within 180 days after the date of enactment.

(2) The proposal deletes the limitation on maximum eligible basis of each unit in a credit project. However, the proposal contemplates that the allocating agency make determinations as to the reasonableness of developmental and operational costs of credit projects.

(3) The proposal modifies the provision relating to community service areas to provide that such areas are included in eligible basis as functionally related and subordinate facilities if (a) the size of the facilities is commensurate with tenant needs, (b) the facilities are designed to serve qualifying tenant populations and employees of the building owner, and (c) no more than twenty percent of the housing project's eligible basis is attributable to such facilities.

B. Targeted Jobs Tax Credit

The proposal would include the following modifications to the extension of the targeted jobs tax credit ("TJTC") program, as reported by the Finance Committee in H.R. 3040:

(1) The proposal would make the credit available to employers of long-term unemployed individuals. For these purposes, a long-term unemployed individual is defined as someone who has exhausted eligibility for unemployment compensation before the hiring date. The maximum credit for this new category of targeted jobs will be 40 percent of the

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[1] See S. Rept. 102-300, June 19, 1992.

first $3,000 of qualified first-year wages. To be eligible for the credit, (a) the employee must remain employed for a minimum of 120 days; and (b) the employer must certify that a reasonable attempt was made to specifically recruit the long-term unemployed.

(2) The proposal would also modify the overall credit rule to require a minimum of 90 days of employment for each eligible employee. Present-law requires the lesser of 90 days or 120 hours of wages.

The proposal would be effective for employees hired within six months of the date of enactment. The proposal also would provide for extensions of the eligibility of the long-term unemployed for the credit for additional six-month periods if the national unemployment rate exceeds 7 percent in any future month.

C. Luxury Excise Tax; Excise Tax on Diesel Fuel Used in Noncommercial Motorboats

1. Luxury excise tax on demonstrator vehicles

The proposal would exempt the dealer from paying the luxury tax on demonstrator vehicles. Under the proposal, the tax would not be paid until the automobile is sold. The tax would be levied on the sales price of the automobile. The proposal would be effective for dealer purchases of vehicles after June 30, 1992.

2. Excise tax on diesel fuel used in noncommercial motorboats

The proposal would make the following modification to the extension of the current 20.1-cents-per-gallon diesel fuel excise taxes to diesel fuel used by boats, as reported by the Finance Committee in H.R. 3040:

The proposal would provide that the tax imposed on diesel fuel used in noncommercial motorboats expire after September 30, 1997.

D. Treatment of Intangible Assets

The proposal generally is the same as that contained in H.R. 3040, as reported by the Finance Committee. The modified proposal would provide that the election to apply the proposal retroactively would apply to open tax years of the taxpayer, even if the tax year that the intangible asset was acquired is closed.

VI. TAXPAYER BILL OF RIGHTS 2

1. Taxpayer Advocate

a. Establishment of position of Taxpayer Advocate within Internal Revenue Service

Present Law

The Office of the Taxpayer Ombudsman was created by the IRS in 1979. The Taxpayer Ombudsman's duties are to serve as the primary advocate, within the IRS, for taxpayers. As the taxpayers' advocate, the Taxpayer Ombudsman participates in an ongoing review of IRS policies and procedures to determine their impact on taxpayers, receives ideas from the public concerning tax administration, identifies areas of the tax law that confuse or create an inequity for taxpayers, and supervises cases handled under the Problem Resolution Program. Under current procedures, the Taxpayer Ombudsman is selected by the Commissioner of the IRS and serves at his discretion.

Description of Proposal

The proposal would establish a new position, Taxpayer Advocate, within the IRS. This would replace the position of Taxpayer Ombudsman. The Advocate would report directly to the Commissioner. Compensation of the Advocate would be at a level equal to that of the IRS Chief Counsel.

The proposal also would establish the Office of Taxpayer Advocate within the IRS. All problem resolution officers would be part of that office, and would be under the supervision and direction of the Taxpayer Advocate. The functions of the office would be (1) to assist taxpayers in resolving problems with the IRS, (2) to identify areas in which taxpayers have problems in dealings with the IRS, (3) to propose changes (to the extent possible) in the administrative practices of the IRS that will mitigate those problems, and (4) to identify potential legislative changes that may mitigate those problems.

The Taxpayer Advocate would be required to make two annual reports to the tax-writing Committees. The first report would contain the objectives of the Taxpayer Advocate for the next calendar year. This report would contain full and substantive analysis, in addition to statistical information and would be due not later than Octobe 31 of each year. The second report would be on the activities of the Taxpayer Advocate during the previous fiscal year. The report must identify the initiatives the Taxpayer Advocate has taken to improve taxpayer services and IRS responsiveness, contain recommendations received from individuals who have the authority to issue a TAO, contain a

summary of at least 20 of the most serious problems which taxpayers have in dealing with the IRS, describe in detail the progress made in implementing these recommendations, include recommendations for such administrative and legislative action as may be appropriate to resolve such problems, and to include other such information as the Taxpayer Advocate may deem advisable. The Commissioner is required to establish internal procedures that will ensure a formal IRS response to all recommendations submitted to the Commissioner by the Taxpayer Advocate. This report is due not later than June 30 of each year.

Effective Date

The proposal would be effective on the date of enactment. The first annual reports of the Taxpayer Advocate would be due June and October, 1993.

b. Expansion of authority to issue Taxpayer Assistance Orders

Present Law

Section 7811(a) authorizes the Taxpayer Ombudsman to issue a Taxpayer Assistance Order (TAO). TAOs may order the release of taxpayer property levied upon by the IRS and may require the IRS to cease any action, or refrain from taking any action if, in the determination of the Taxpayer Ombudsman, the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered.

Description of Proposal

The proposal would provide the Taxpayers' Advocate with broader authority to affirmatively take any action with respect to taxpayers who would otherwise suffer a significant hardship as a result of the manner in which the IRS is administering the tax laws. For example, the Taxpayers' Advocate's scope of power will specifically include (1) the authority to abate assessments, (2) grant or expedite refund requests, and (3) stay collection activity. The proposal also would provide that a TAO may specify a time period within which the TAO must be followed. Finally, the proposal would provide that only the Taxpayer Advocate, the Commissioner of the IRS, or a superior of those two positions, as well as a delegate of the Taxpayer Advocate, may modify or rescind a TAO. The Taxpayers' Advocate is not intended to have the power to make substantive determinations.

Effective Date

The proposal would be effective on the date of enactment.

2. **Modifications to Installment Agreement Provisions**

a. Notification of reasons for termination or denial of installment agreements

Present Law

Section 6159 authorizes the IRS to enter into written installment agreements with taxpayers to facilitate the collection of tax liabilities. In general, the IRS has the right to terminate (or in some instances, alter or modify) such agreements if the taxpayer provided inaccurate or incomplete information before the agreement was entered into, if the taxpayer fails to make a timely payment of an installment or another tax liability, if the taxpayer fails to provide the IRS with a requested update of financial condition, if the IRS determines that the financial condition of the taxpayer has changed significantly, or if the IRS believes collection of the tax liability is in jeopardy. If the IRS determines that the financial condition of a taxpayer that has entered into an installment agreement has changed significantly, the IRS must provide the taxpayer with a written notice that explains the IRS determination at least 30 days before altering, modifying or terminating the installment agreement. No notice is statutorily required if the installment agreement is altered, modified, or terminated for other reasons.

Description of Proposal

The proposal would require the IRS to notify taxpayers 30 days before altering, modifying, or terminating any installment agreement for any reason other than that the collection of tax is determined to be in jeopardy. The IRS must include in the notification an explanation of why the IRS intends to take this action. The proposal also would require that the IRS notify taxpayers 30 days before denying any installment agreement for any reason other than that the collection of tax is determined to be in jeopardy.

Effective Date

The proposal would be effective six months after the date of enactment.

b. Administrative review of denial of requests for, or termination of, installment agreements

Present Law

A taxpayer whose request for an installment agreement is denied can appeal to successively higher levels of Collection Division management, including the District Director. The IRS is currently testing an appeal process for various collection actions, including installment agreements, that will permit taxpayers to appeal these collection actions to Appeals Division personnel.

Description of Proposal

The proposal would require the IRS to establish additional procedures for an independent administrative review of denials of requests for installment agreements and terminations of installment agreements.

Effective Date

The proposal would be effective on January 1, 1993.

3. Interest

a. Extension of interest-free period for payment of tax after notice and demand

Present Law

In general, a taxpayer must pay interest on late payments of tax. An interest-free period of ten days is provided to taxpayers who pay the tax due within ten days of notice and demand.

Description of Proposal

The proposal would extend the interest-free period provided to taxpayers for the payment of the tax liability reflected in the notice from 10 days to 21 days, provided that the total tax liability shown on the notice of deficiency is less than $100,000.

Effective Date

The proposal would apply in the case of any notice and demand given after the date six months after the date of enactment.

b. 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 generally expand the authority of the IRS to abate interest. The proposal permits the IRS to abate interest with respect to any unreasonable error or delay for eligible taxpayers. An eligible taxpayer is a taxpayer who meets the net worth requirements referenced in section 7430(c)(4)(A)(iii).

Effective Date

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

4. Joint Returns

a. Disclosure of collection activities with respect to joint returns

Present Law

The IRS does not disclose collection information to spouses that have filed a joint return.

Description of Proposal

If a tax deficiency with respect to a joint return is assessed, and the individuals filing the return are no longer married or no longer reside in the same household, the proposal would permit the IRS to disclose in writing (in response to a written request by one of the individuals) to that individual whether the IRS has attempted to collect the deficiency from the other individual, the general nature of the collection activities, and the amount (if any) collected.

Effective Date

The proposal would be effective on the date of enactment.

b. 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.

5. Collection Activities

a. Modifications to lien and levy provisions

i. Withdrawal of public notice of lien

Present Law

The IRS files a notice of lien in the public record, in order to protect the priority of a tax lien. A notice of tax lien provides public notice that a taxpayer owes the Government money. The IRS is required to issue a certificate of release for such notices for erroneous liens only.

Description of Proposal

The proposal would allow the IRS to withdraw a public notice of tax lien prior to payment in full by the indebted taxpayer without prejudice, if the Secretary determines that (1) the filing of the notice was premature or otherwise not in accordance with the administration procedures of the IRS, (2) the taxpayer has entered into an installment agreement to satisfy the tax liability with respect to which the lien was filed, (3) the withdrawal of the lien will facilitate collection of the tax liability, or (4) the withdrawal of the lien would be in the best interests of the taxpayer (as determined by the Taxpayers' Advocate) and of the Government. The proposal also would require that, at the written request of the taxpayer, the IRS make reasonable efforts to give

notice of the withdrawal of a lien to creditors, credit reporting agencies, and financial institutions specified by the taxpayer.

Effective Date

The proposal would be effective on the date of enactment.

ii. Return of levied property

Present Law

The IRS is authorized to return levied property to a taxpayer only when the taxpayer has overpaid its liability to tax, interest, and penalty.

Description of Proposal

The proposal would allow the IRS to return property (including money deposited in the Treasury) that has been levied upon if the Secretary determines that (1) the levy was premature or otherwise not in accordance with the administrative procedures of the IRS, (2) the taxpayer has entered into an installment agreement to satisfy the tax liability, (3) the return of the property will facilitate collection of the tax liability, or (4) the return of the property would be in the best interests of the taxpayer (as determined by the Taxpayers' Advocate) and the Government.

Effective Date

The proposal would be effective on the date of enactment.

iii. Modifications in certain levy exemption amounts

Present Law

Property exempt from levy includes personal property with a value of up to $1,650, and books and tools necessary for the taxpayer's trade, business, or profession with a value of up to $1,100.

Description of Proposal

The proposal would increase the exemption amounts to $1,700 for personal property and $1,200 for books and tools. Both these amounts are indexed for inflation commencing January 1, 1993.

Effective Date

The proposal would be effective on the date of enactment.

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 also 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.

c. Notification of examination

Present Law

In general, the IRS notifies taxpayers in writing prior to commencing an examination and encloses a copy of Publication 1, "Your Rights as a Taxpayer," with the notice. Sometimes, however, the IRS uses the telephone to schedule an examination. Presently, the IRS may be approaching taxpayers, requesting the taxpayer's books and records, but not notifying taxpayers of examination. If the taxpayer is contacted and the agent requests to review the books and records, a written notice should be required.

Description of Proposal

The proposal would require the IRS to notify a taxpayer in writing prior to commencing examinations under all subtitles of the Code and to provide the taxpayer with an explanation of the examination process prior to commencing the examination. Such notice will include an explanation of the process as described in section 7521. The proposal would exempt from this requirement any examination with respect to

which the Secretary determines (1) that it is in connection with a criminal investigation, (2) that the collection of the tax is in jeopardy, (3) that the requirements are inconsistent with national security needs, or (4) that the requirements would interfere with the effective conduct of a confidential law enforcement or foreign counterintelligence activity. This provision would not preclude the IRS from using the telephone to attempt to schedule an examination, so long as the written notice required by this provision has been given.

Effective Date

The proposal would be effective on the date of enactment.

d. Modification of certain limits on recovery of civil damages for unauthorized collection activities

Present Law

A taxpayer may sue the United States for up to $100,000 of damages caused by an officer or employee of the IRS who recklessly or intentionally disregards provisions of the Internal Revenue Code or the Treasury regulations promulgated thereunder.

Description of Proposal

The proposal would increase the cap to $1 million with respect to reckless or intentional acts. In addition, it would permit a taxpayer to sue the United States for up to $100,000 of damages caused by an officer or employee of the IRS who negligently disregards provisions of the Internal Revenue Code or the Treasury regulations promulgated thereunder.

Effective Date

The proposal would apply to actions by IRS employees that occur after the date of enactment.

e. Designated summons

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.[1]

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.

Under current internal procedures of the IRS, no designated summons is issued unless first reviewed by the Office of Chief Counsel to the IRS, including review by an IRS Deputy Regional Counsel for the Region in which the examination of the corporation's return is being conducted.

Description of Proposal

The proposal would require that issuance of any designated summons with respect to a corporation's tax return must be preceded by review of such issuance by the Regional Counsel, Office of Chief Counsel to the IRS, for the Region in which the examination of the corporation's return is being conducted.

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[1] 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).

In addition, the proposal would require that the corporation whose return is in issue be promptly notified in writing in any case where the Secretary issues a designated summons (or another summons, the litigation over which suspends the running of the assessment period under the designated summons procedure) to a third party. It is expected that the IRS generally will meet this requirement by issuing such notice on the same day that it issues such summons, and by transmitting such notice to the corporation in a manner reasonably designed to bring it to the prompt attention of an agent of the corporation responsible for communicating with the IRS in connection with the examination.

Effective Date

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

6. Information Returns

a. Phone numbers of person providing payee statement required to be shown on such statement

Present Law

Information returns must contain the name and address of the payor.

Description of Proposal

The proposal would require that information returns contain the name, address, and phone number of the payor's information contact. A payor may have the option of providing the name and phone number of the department with the relevant information. It is intended that the telephone number provide direct access to individuals with immediate resources to resolve a taxpayer's questions in an expeditious manner.

Effective Date

The proposal would apply to statements required to be furnished after December 31, 1992 (determined without regard to any extension).

b. Civil damages for fraudulent filing of information returns

Present Law

Federal law provides no private cause of action to a taxpayer who is injured because a false or fraudulent

information return has been filed with the IRS asserting that payments have been made to the taxpayer.

Description of Proposal

The proposal would provide that, if any person willfully files a false or fraudulent information return with respect to payments purported to have been made to another person, the other person may bring a civil action for damages against the person filing that return. A copy of the complaint initiating the action must be provided to the IRS. Recoverable damages would be the greater of $5,000 or the amount of actual damages (including the costs of the action). The court must specify in its judgment what the correct amount that should have been reported on the information return should have been (if any). An action seeking damages under this provision would be required to be brought within four years after the filing of the false or fraudulent information return, or one year after discovery of the filing of the false or fraudulent information return, whichever is later.

Effective Date

The proposal would apply to false or fraudulent information returns filed after the date of enactment.

c. Requirement to verify accuracy of information returns

Present Law

Deficiencies determined by the IRS are generally afforded a presumption of correctness.

Description of Proposal

The proposal would provide that, in any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return (Form 1099) filed by a third party and the taxpayer has fully cooperated with the IRS, the Government shall present reasonable and probative information concerning the deficiency (in addition to the information return itself). One way in which the taxpayer must cooperate with the IRS is to bring the reasonable dispute over the item of income to the attention of the IRS within a reasonable period of time.

Effective Date

The proposal would be effective on the date of enactment.

7. Modification To Penalty For Failure To Collect and Pay Over Tax

a. Preliminary notice requirements

Present Law

A "responsible person" is subject to a penalty equal to the amount of trust fund taxes that are not collected or paid to the government on a timely basis. An individual the IRS has identified as a responsible person is permitted an administrative appeal on the question of responsibility.

Description of Proposal

The proposal would require the IRS to issue a notice to an individual the IRS had determined to be a responsible person with respect to unpaid trust fund taxes at least 60 days prior to issuing a notice and demand for the penalty. The statute of limitations would not expire before the date 90 days after the date on which the notice was mailed. The provision does not apply if the Secretary finds that the collection of the penalty is in jeopardy.

Effective Date

The proposal would apply to failures occurring after the date of enactment.

b. No penalty if prompt notification of IRS

Present Law

A responsible person may be subject to a penalty equal to 100 percent of the amount of trust fund taxes that are not collected and paid to the Government on a timely basis.

Description of Proposal

The proposal would provide that a responsible person who notifies the IRS within 21 days of the failure to pay over trust fund taxes to the Government is not liable for this penalty, so long as the notification is made prior to the IRS's contacting the business about the failure to pay over the taxes, and provided that the person is not a significant owner (of a 5-percent or more interest). The proposal would not apply if the failure to pay is part of a plan to defraud the Government. The proposal would apply only once to a taxpayer in that taxpayer's lifetime and once to a corporation in its existence. The proposal could not operate in such a way as to eliminate all responsible persons from responsibility.

Effective Date

The proposal would apply in the case of failures to collect and pay over tax that occur after the date of enactment.

c. Disclosure of certain information where more than one person subject to penalty

Present Law

The IRS may not disclose to a responsible person the IRS's efforts to collect unpaid trust fund taxes from other responsible persons, who may also be liable for the same tax liability.

Description of Proposal

The proposal would require the IRS, if requested in writing by a person considered by the IRS to be a responsible person, to disclose in writing to that person the name of any other person the IRS has determined to be a responsible person with respect to the tax liability. The IRS would be required to disclose in writing whether it has attempted to collect this penalty from other responsible persons, the general nature of those collection activities, and the amount (if any) collected. Failure by the IRS to follow this provision would not absolve any individual for any liability for this penalty.

Effective Date

The proposal would be effective on the date of enactment.

8. Awarding of Costs And Certain Fees

a. Motion for disclosure of information

Present Law

A taxpayer that successfully challenges a determination of deficiency by the IRS may recover attorneys' fees and other administrative and litigation costs if the taxpayer qualifies as a "prevailing party." A taxpayer qualifies as a prevailing party if it (1) establishes that the position of the United States was not substantially justified; (2) substantially prevails with respect to the amount in controversy or with respect to the most significant issue or set of issues presented; and (3) meets certain net worth and (if the taxpayer is a business) size requirements.

Description of Proposal

The proposal would provide that once a taxpayer has substantially prevailed, the taxpayer may file a motion for an order requiring the disclosure (within a 60-day period) of all information and copies of relevant records in the possession of the IRS with respect to the taxpayer's case and the substantial justification for the position taken by the IRS. Disclosure under this provision would be subject to the confidentiality restrictions of section 6103. Relevant records would be required to be disclosed within a reasonable period of time. The provision would not require the disclosure of privileged or otherwise non-disclosable information.

Effective Date

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

b. Increased limit on attorney fees

Present Law

Attorneys' fees recoverable by prevailing parties as litigation or administrative costs are limited to a maximum of $75 per hour.

Description of Proposal

The proposal would raise the statutory rate to $110 per hour, indexed for inflation beginning after 1992.

Effective Date

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

c. Failure to agree to extension not taken into account

Present Law

To qualify for an award of attorney's fees, the taxpayer must have exhausted the administrative remedies available within the IRS. The IRS has taken the position in regulations that attorney's fees cannot be awarded if the taxpayer has not agreed to extend the statute of limitations. In Minahan v. Commissioner, 88 T.C. 492 (1987), the Tax Court held that regulation invalid insofar as it provides that a taxpayer's refusal to consent to extend the statute of limitations is to be taken into account in determining whether the taxpayer has exhausted administrative remedies available to the taxpayer.

Description of Proposal

The proposal would provide that any failure to agree to an extension of the statute of limitations cannot be taken into account for purposes of determining whether a taxpayer has exhausted the administrative remedies for purposes of determining eligibility for an award of attorney's fees.

Effective Date

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

9. Other Provisions

a. Relief from retroactive application of Treasury Department Regulations

Present Law

Treasury may prescribe the extent (if any) to which regulations shall be applied without retroactive effect.

Description of Proposal

Temporary and proposed regulations would be required to have an effective date no earlier than the date of publication in the Federal Register or the date on which any notice substantially describing the expected contents of such regulation is issued to the public. This proposal may be superseded by a legislative grant authorizing the Treasury to prescribe the effective date with respect to a statutory provision. The Treasury would be permitted to issue retroactive temporary or proposed regulations to prevent abuse of the statute. The Treasury would also be permitted to issue retroactive temporary, proposed, or final regulations to correct a procedural defect in the issuance of a regulation. The Treasury may provide that taxpayers may elect to apply a temporary or proposed regulation retroactively from the date of publication of the regulation. Final regulations may take effect from the date of publication of the temporary or proposed regulation to which they relate. The proposal would not apply to any regulation relating to internal Treasury Department policies, practices, or procedures. Present law with respect to rulings is unchanged.

There may be additional instances in which retroactive application of Treasury regulations has created undue hardship. The proposal does not preclude the Congress from both examining these cases and providing any appropriate relief in the future.

Effective Date

The proposal would apply with respect to any temporary or proposed regulation published on or after July 28, 1992, and any temporary or proposed regulation published before July 28, 1992, and published as a final regulation after that date.

b. Required content of certain notices

Present Law

The Code requires the IRS to describe the basis for and identify the amounts of tax due, interest, penalties, and any other additional amounts owed in the notice of deficiency sent to taxpayers.

Description of Proposal

The proposal would require that the IRS set forth the components of and explanation for each specific adjustment that is the basis for the total tax deficiency. An inadequate description would not invalidate the notice.

Effective Date

The proposal would apply to notices sent after the date six months after the date of enactment.

c. Treatment of substitute returns for purposes of the penalty for failure to pay taxes

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 file 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.

d. Unauthorized enticement of information disclosure

Present Law

There is no statutory disincentive for enticing a tax professional to disclose information about clients in exchange for forgiving the taxes of the professional.

Description of Proposal

If any officer or employee of the United States intentionally compromises the determination or collection of any tax due from an attorney, certified public accountant, or enrolled agent representing a taxpayer in exchange for information conveyed by the taxpayer to the attorney, certified public accountant or enrolled agent for purposes of obtaining advice concerning the taxpayer's tax liability, such information shall not be admissible in any judicial proceeding. In addition, the taxpayer may bring a civil action for damages against the United States in a district court of the United States. Upon a finding of liability, damages shall equal the lesser of $500,000 or the sum of (i) actual economic damages sustained by the taxpayer as a proximate result of the information disclosure and (ii) the costs of the action. These remedies shall not apply to information conveyed to an attorney, certified public accountant or enrolled agent for the purpose of perpetrating a fraud or crime.

Effective Date

The proposal would apply to actions taken after the date of enactment.

10. Form Modifications

a. Explanation of certain provisions

Present Law

Section 6159 authorizes the IRS to enter into written installment agreements with any taxpayer. Section 7122 authorizes the IRS to accept offers in compromise from taxpayers in certain situations. Section 6161 authorizes the IRS to extend the time for payment of tax.

Description of Proposal

The proposal would require the IRS to take such actions as may be appropriate (including improved publicity) to ensure that taxpayers are aware of the availability of installment agreements, offers in compromise, and the extension of time to pay tax. The IRS would be required to do so in both the income tax return instructions and collection notices.

Effective Date

The proposal would be effective on the date of enactment.

b. Improved procedures for notifying IRS of change of address or name

Present Law

Generally, the IRS posts the new address of a taxpayer only upon the filing of the subsequent tax return which contains a new address or if the taxpayer submits a Form 8822, Change of Address, to the IRS.

Description of Proposal

The proposal would require the IRS to provide improved procedures for taxpayers to notify the IRS of changes in names or addresses. In addition, the proposal would require that the IRS institute procedures before 1993 for the timely updating of all IRS records with change of address information provided to the IRS by taxpayers.

Effective Date

The proposal would be effective on the date of enactment.

c. Rights and responsibilities of divorced individuals

Present Law

The IRS provides information on the rights and responsibilities of divorced individuals in Publication 504, Tax Information for Divorced or Separated Individuals. This publication is not as widely utilized as Publication 1, Your Rights As a Taxpayer.

Description of Proposal

The proposal would require the IRS to include a section on the rights and responsibilities of divorced individuals in Publication 1, Your Rights As a Taxpayer.

Effective Date

The proposal would be effective on the date of enactment.

d. Penalties relating to failure to collect and pay over tax

i. Public information requirements

Present Law

Under section 6672, a "responsible person" is subject to a penalty equal to the amount of trust fund taxes that are not collected and paid to the Government on a timely basis.

Description of Proposal

The proposal would require the IRS to print warnings on payroll tax deposit coupon books and appropriate tax returns indicating that certain employees may be liable for this penalty, and to develop a special information packet relating to this penalty.

Effective Date

The proposal would be effective on the date of enactment.

ii. Board members of tax-exempt organizations

Present Law

Under section 6672, "responsible persons" of tax-exempt organizations are subject to a penalty equal to the amount of trust fund taxes that are not collected and paid to the Government on a timely basis.

Description of Proposal

The proposal would clarify that the section 6672 responsible person penalty is not to be imposed on volunteer, unpaid members of any board of trustees or directors of a tax-exempt organization to the extent such members are solely serving in an honorary capacity, do not participate in the day-to-day or financial activities of the organization, and do not have actual knowledge of the failure. The proposal could not operate in such a way as to eliminate all responsible persons from responsibility.

The proposal would require the IRS to develop materials to better inform board members of tax-exempt organizations (including voluntary or honorary members) that they may be treated as responsible persons. The IRS would be required to make such materials routinely available to tax-exempt

organizations. The proposal also would require the IRS to clarify its instructions to IRS employees on application of the responsible person penalty with regard to honorary or volunteer members of boards of trustees or directors of tax-exempt organizations.

Effective Date

The proposal would be effective on the date of enactment.

iii. Prompt notification

Present Law

The IRS is not required to notify promptly taxpayers who fall behind in depositing trust fund taxes.

Description of Proposal

The proposal would require the IRS, to the maximum extent practicable, to notify all taxpayers with delinquent taxes described under section 6672 of the Code within 30 days after the return was filed reflecting the delinquency or after the date on which the first indication that there has been a failure to make a timely and complete deposit. If the taxpayer is an entity, the Secretary shall notify the entity and the entity shall be required to notify, within 15 days of such notification by the Secretary, all officers, general partners, trustees or other managers of the failure to make a timely and complete deposit. Failure to provide this notice would not absolve any individual from any liability for this penalty.

Effective Date

The proposal would be effective on the date of enactment.

e. Required notice to taxpayers of certain payments

Present Law

If the IRS receives a payment without sufficient information to properly credit it to a taxpayer's account, the IRS may attempt to contact the taxpayer. If contact cannot be made, the IRS places the payment in an unidentified remittance file.

Description of Proposal

The proposal would require the IRS to make reasonable efforts to notify, within 60 days, those taxpayers who have

made payments which the IRS cannot associate with any outstanding tax liability.

Effective Date

The proposal would be effective on the date of enactment.

11. Studies

a. Pilot program for appeal of enforcement actions

Present Law

A taxpayer who disagrees with an IRS collection action generally can only appeal to successively higher levels of management in the Collection Division. Certain cases involving the 6672 penalty, offers-in-compromise, and employment tax issues may, however, be appealed to the Appeals Division.

Description of Proposal

The proposal would require the IRS to establish a one-year pilot program to evaluate the merits of allowing an independent appeal, by the taxpayer, to the Appeals Division of enforcement actions (including lien, levy, and seizure actions) where the deficiency was assessed without the actual knowledge of the taxpayer, where the deficiency was assessed without an opportunity for administrative appeal, and in other appropriate circumstances.

Effective Date

The IRS would be required to report to the tax-writing committees by June 30, 1993, on the effectiveness of this pilot program.

b. Study on taxpayers with special needs

Present Law

The IRS is responsible for providing timely and accurate assistance to taxpayers who want to comply with Federal tax laws.

Description of Proposal

The proposal would require the IRS to conduct a study of ways to assist the elderly, physically impaired, foreign-language speaking, and other taxpayers with special needs to comply with the tax laws.

Effective Date

The report (and any recommendations) would be required to be submitted to the tax-writing committees by June 30, 1993.

c. **Reports on taxpayer rights education program**

Present Law

The IRS is currently conducting a program to educate revenue officers concerning the rights of taxpayers.

Description of Proposal

The proposal would require the IRS to report to the tax-writing Committees on its taxpayer rights education program for its officers and employees, including the scope and content of the program, and on the effectiveness of the program.

Effective Date

The report on the scope and content of the taxpayer-rights education program would be required to be submitted to the tax-writing committees by April 1, 1993, and the report on the effectiveness of the program would be required to be submitted by June 30, 1993.

d. **Biennial reports on misconduct By IRS employees**

Present Law

As mandated by the Inspector General Act, every six months the Inspector General of the Department of the Treasury receives information from the IRS for the Secretary of the Treasury's semiannual report to Congress on employee misconduct. The Inspector General Act, in part, requires that these reports include summary information and descriptions of significant investigative activities and a summary of matters referred to prosecuting authorities and the prosecutions and convictions that have resulted.

Description of Proposal

The proposal would require the IRS to report to the tax-writing committees every two years on all cases involving complaints about IRS employee misconduct and on the disposition of those complaints.

Effective Date

The first report would be required to be submitted during June 1993.

e. **Study of notices of deficiency**

Present Law

Under section 6212, the IRS is required to send a notice of tax deficiency to taxpayers by registered or certified mail.

Description of Proposal

The proposal would require the GAO to study the effectiveness of current IRS efforts to notify taxpayers with regard to tax deficiencies under section 6212, the number of registered or certified letters and other notices returned to the IRS as undeliverable, any follow-up action taken by the IRS to locate the taxpayers, the effect that failures to receive actual notice have on taxpayers, and recommendations on how the IRS can better notify taxpayers of tax deficiencies.

Effective Date

The report and recommendations would be required to be furnished by June 30, 1993.

f. **Notice and form accuracy study**

Present Law

The IRS is responsible for providing accurate and instructive notices, forms, and instructions to taxpayers to assist them in complying with Federal tax laws.

Description of Proposal

The proposal would require the GAO to study annually the accuracy of 25 of the most commonly used IRS forms, notices, and publications. In conducting its review, the GAO would be required to seek and consider the comments of organizations representing taxpayers, employers, and tax professionals.

Effective Date

The initial report (and any recommendations) would be required to be submitted to the tax-writing committees by June 30, 1993.

g. **IRS employees' suggestions study**

Present Law

The IRS maintains several programs to encourage and reward employees who make suggestions for improving the administration of the tax system.

Description of Proposal

The proposal would require the GAO to conduct a review of the IRS employee suggestion programs. The study would be required to include a review of all suggestions that were accepted and rewarded by the IRS, an analysis as to how many of these suggestions were implemented, and why the remaining suggestions were not implemented.

Effective Date

The report (and any recommendations) would be required to be submitted to the tax-writing committees by June 30, 1993.

VII. PROVISIONS RELATING TO CONTRIBUTIONS TO CHARITIES

A. Repeal Application of Minimum Tax to Gifts of All Appreciated Property

Present Law

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

For purposes of computing alternative minimum taxable income (AMTI), the deduction for charitable contributions of capital gain property (real, personal, or intangible) is disallowed to the extent that the fair-market value of the property exceeds its adjusted basis (sec. 57(a)(6)). However, in the case of a contribution made in a taxable year beginning in 1991 or made before July 1, 1992, in a taxable year beginning in 1992, this rule does not apply to contributions of tangible personal property.

Description of Proposal

Permanent AMT relief for donated appreciated property

The proposal would permanently repeal section 57(a)(6). Thus, the difference between the fair-market value of donated appreciated property (real, personal, or intangible property) and the adjusted basis of such property would not be treated as a tax preference item for alternative minimum tax (AMT) purposes. Taxpayers would be allowed to claim for all charitable contributions the same deduction for both regular tax and AMT purposes.

Treasury report on advance valuation procedure

As provided for in H.R. 3040 (as reported by the Committee), the Treasury Department is directed to report to Congress not later than one year after enactment on the development of a procedure under which taxpayers could elect to seek an agreement with the IRS as to the value of tangible personal property prior to the donation of such property to a qualifying charitable organization, including the setting of

possible threshold amounts for claimed value (and the payment of fees by taxpayers), possible limitations on applying the procedure only to items with significant artistic or cultural value, and recommendations for legislative action needed to implement the proposed procedure.

Effective Date

The proposal would be effective for contributions made in calendar years ending on or after December 31, 1992. The Secretary of the Treasury would be required to report to Congress not later than one year after enactment on the development of an advance valuation procedure for certain charitable contributions of tangible personal property.

B. Allocation and Apportionment of Deductions for Charitable Contributions

Present Law

The credit for foreign income taxes is limited to the amount of U.S. tax otherwise payable on foreign source taxable income. (This is known as the foreign tax credit limitation.) The foreign tax credit is not available against U.S. tax on U.S. source taxable income. A shift in the source of net income from foreign to U.S. may increase net U.S. tax for some taxpayers by reducing the foreign tax credit limitation.

To compute the foreign tax credit limitation, foreign source taxable income is computed by (1) determining the items of gross income that are from foreign sources, and then (2) subtracting from those items the portion of the taxpayer's deductions that is allocated or apportioned to foreign source gross income. A shift in the allocation or apportionment of expenses from U.S. source to foreign source gross income decreases foreign source taxable income. This decrease may increase U.S. tax by reducing the foreign tax credit limitation.

Deductions for expenses that cannot definitely be allocated to some item or class of gross income must be apportioned ratably between gross income from U.S. sources and gross income from foreign sources. In addition, for a taxpayer that is a member of an affiliated group, expenses that are not directly allocated or apportioned to any specific income producing activity generally must be allocated and apportioned under a so-called "one-taxpayer rule"--that is, as if all of members of the affiliated group were a single corporation. Charitable contribution deductions generally are treated as not definitely related to any gross income or income producing activity, and therefore are ratably apportioned and subject to the one-taxpayer rule.

Description of Proposal

Under the proposal, taxpayers would be permitted to apportion 55 percent of their otherwise-allowable charitable contribution deductions to gross income from U.S. sources, and the remaining 45 percent of such deductions would be apportioned ratably, as under present law, between U.S. source gross income and foreign source gross income. Also as under present law, all corporations included in an affiliated group would be treated as a single corporation for purposes of the apportionment of charitable contribution deductions.

Effective Date

The proposal would be effective for charitable contributions made on or after July 1, 1993.

C. Substantiation and Information Disclosure Requirements for Certain Charitable Contributions

Present Law

An individual taxpayer who itemizes deductions must separately state (on Schedule A to the Form 1040) the aggregate amount of charitable contributions made by cash or check and the aggregate amount made by donated property other than cash or check.

A taxpayer is not required to provide specific information on his or her return regarding a claimed charitable contribution made by cash or check; nor in such a case is a donee organization required to file an information return with the IRS, regardless of the amount of cash or check involved. However, taxpayers must provide certain information (on Form 8283) if the amount of the claimed contribution for all noncash contributions exceeds $500.

A payment (regardless of whether it is termed a "contribution") in exchange for which the payor receives an economic benefit is not deductible under section 170, except to the extent that the taxpayer can demonstrate that the payment exceeded the fair-market value of the benefit received from the charity.[1]

Description of Proposal

The proposal would include the following two parts:

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[1] See Rev. Rul. 67-246, 1967-2 C.B. 104.

Under current IRS practice, certain small items and token benefits (e.g., key chains and bumper stickers) that have insubstantial value are disregarded, such that the full amount of the contribution is deductible. Rev. Proc. 90-12, 1990-1 C.B. 471, provides that tokens or benefits given to the donor in connection with a contribution will be considered to have insubstantial value if (1) the payment occurs in the context of a fundraising campaign in which the charity informs patrons how much of their payment is a deductible contribution, <u>and</u> (2) <u>either</u> (a) the fair-market value of all the benefits received in connection with the payment is not more than 2% of the payment, or $50, <u>whichever is less</u>, <u>or</u> (b) the payment made by the patron is $25 or more (adjusted for inflation) and the only benefits received in connection with the payment are token items (e.g., key chains or mugs) which bear the organization's name or logo and which (in the aggregate) are within the limits for "low-cost items" under section 513(h)(2).

(1) Substantiation requirement.--No deduction would be allowed under section 170 for any contribution of $100 or more unless the taxpayer has written substantiation from the donee organization of the contribution (including an indication of the value of any good or service that has been provided to the donor in exchange for making the gift to the donee).

This proposal would not impose an information reporting requirement upon charities, but would place the responsibility upon taxpayers who claim an itemized deduction for a contribution of $100 or more to request (and maintain in their records) substantiation from the charity of their contribution (and any good or service received in exchange).[2] Taxpayers could not simply rely on a cancelled check as substantiation for a donation in excess of $100.

The substantiation would have to be obtained by the taxpayer prior to filing his or her return for the taxable year in which the contribution was made (or if earlier, the due date, including extensions, for such return). Substantiation would not be required if the donee organization files a return with the IRS (in accordance with Treasury regulations) that provides information sufficient to substantiate the amount of the deductible contribution.

(2) Information disclosure for quid pro quo contributions.--Charitable organizations that receive quid pro quo contributions (meaning a payment made partly as a contribution and partly in consideration for goods or services furnished to the donor) would be required to inform donors of a good faith estimate of the value of goods or services furnished to the donor and the net amount of the contribution that is deductible as a charitable contribution.

The disclosure requirement would apply to all quid pro quo contributions regardless of the dollar amount of the contribution involved (i.e., even in cases with donations less than $100), and the disclosure would have to be made by the charity in connection with either the solicitation or receipt of the contribution. However, the proposal would not apply if de minimis, token goods or services are given to a donor (see Rev. Proc. 90-12, discussed above), nor would it apply to transactions that have no donative element (e.g., sales of goods by a museum gift shop that are not, in part,

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[2] In the case where a taxpayer makes a noncash contribution, the taxpayer would be required to obtain from the charity a receipt that describes the donated property (and indicates whether any good or service was given to the taxpayer in exchange), but the proposal would not require the charity to value the property it receives.

donations).

Penalties ($10 per contribution, but capped at $5,000 per fundraising event or mailing) would be imposed upon charities that fail to make the required disclosure, unless the failure was due to reasonable cause.

Effective Date

The proposal would be effective for contributions made on or after January 1, 1993.

D. Corporate Sponsorship Payments Received by Tax-exempt Organizations In Connection With Public Events

Present Law

Although exempt from Federal income tax, tax-exempt organizations generally are subject to the unrelated business income tax (UBIT) on income derived from a trade or business regularly carried on[3] 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.[4] 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.[5]

Description of Proposal

Under the proposal, a sponsorship payment received by a tax-exempt organization described in paragraph (3), (4), (5), or (6) of section 501(c),[6] in connection with the

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[3] In determining whether a trade or business is regularly carried on, regard must be had to the frequency and continuity with which the business activities are conducted and the manner in which such activities are pursued. Specific business activities of a tax-exempt organization will ordinarily be deemed to be regularly carried on if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of taxable entities. See Treas. Reg. sec. 1.513-1(c)(1).

[4] 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).

[5] See Announcement 92-15, 1992-5 I.R.B. 51 (announcing proposed audit guidelines distinguishing sponsorship payments in return for which there is mere acknowledgment of sponsor--and thus no UBIT liability--in contrast to sponsorship payments in return for which substantial economic benefits are conferred upon the sponsor and UBIT liability may be asserted by the IRS).

organization's conduct of a public event would be excluded from the UBIT, provided that --

(1) in return for making the sponsorship payment, the sponsor receives no substantial return benefit other than affiliation with the event of the sponsor's name or logo (but not advertising or promotion of particular products or services offered by the sponsor to the public);

(2) substantially all of the activities that are part of the underlying event are exempt from the UBIT (i.e., the event is substantially related to the organization's tax-exempt purpose, it is not regularly carried on, the work is performed by volunteers, or another present-law UBIT exception applies); and

(3) the net proceeds from the event are used for charitable purposes described in section 170(c)(2)(B).

Examples of public events that would be governed by the proposal include intercollegiate athletic events, concerts, museum exhibitions, fine-arts festivals, and golf tournaments (provided that the other requirements of the proposal are satisfied). No inference would be intended as to the tax treatment under present-law rules of sponsorship payments not governed by the proposal, or sponsorship payments received in connection with events held prior to the date of enactment.

Effective Date

The proposal would be effective for sponsorship payments received in connection with events conducted after the date of enactment.

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[6] In addition, State colleges and universities described in section 511(d)(2)(B) would be eligible for the UBIT exception provided for by the proposal.

VIII. SIMPLIFICATION PROVISIONS

Subpart A. Employee Benefits Simplification

A. Distributions

1. Income averaging

Description of Proposal

The proposal would repeal 5-year forward income averaging for lump-sum distributions. The proposal would retain the special grandfather rules under the Tax Reform Act of 1986 for individuals who had attained age 50 by January 1, 1986.

Effective Date

Distributions after December 31, 1992.

2. $5,000 death benefit exclusion

Description of Proposal

The proposal would repeal the exclusion from gross income of up to $5,000 of employer-provided death benefits.

Effective Date

The proposal would be effective for distributions after December 31, 1992.

3. Recovery of basis

Description of Proposal

The proposal would provide that the portion of an annuity distribution from a qualified retirement plan that represents nontaxable return of basis generally is determined under a method similar to the present-law simplified alternative method provided by the Internal Revenue Service (IRS Notice 88-118). However, the simplified method would not apply if the primary annuitant has attained age 75 on the annuity starting date unless there are at least 5 years of guaranteed payments under the annuity.

Effective Date

The proposal would be effective for annuity starting dates after December 31, 1992.

4. **Minimum required distributions**

Description of Proposal

The proposal would provides that, except in the case of 5-percent owners of an employer and IRA owners, distributions are required to begin by the April 1 of the calendar year following the later of the calendar year in which (1) the employee attains age 70-1/2[1] or (2) the employee retires. As under present law, distributions to 5-percent owners and IRA owners would be required to begin by the April 1 following the year in which the individual attains age 70-1/2.

The benefits of participants who continue to work for an employer after attaining age 70-1/2 would be required to be actuarially increased to take into account the period after age 70-1/2 during which the employee receives no benefits under the plan.

Effective Date

Years beginning after December 31, 1993.

B. Increased Access

1. **Plans targeted to small businesses**

a. **Simplified employee pensions (SEPs)**

Description of Proposal

Salary reduction SEPs

The proposal would provide that employers with 100 or fewer employees may maintain salary reduction SEPs and repeals the 50-percent participation requirement for such SEPs. The safe harbors available to qualified cash or deferred arrangements under the proposal would apply to salary reduction SEPs if employees are notified of the provisions of the SEP.

Eligibility requirements

The proposal would replace the 3-out-of-5 years service requirement under present law with a requirement that employees who have at least 1 year of service must be eligible to participate.

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[1] Age 70-1/2 would be changed to age 70 under another provision of the bill, described below.

Effective Date

Years beginning after December 31, 1992.

b. Private retirement incentives matched by employers (PRIME) accounts

Description of Proposal

The proposal would create a simplified retirement plan for small business called the private retirement incentives matched by employers (PRIME) account. A PRIME account would be an individual retirement plan with respect to which employees could make elective pre-tax contributions of up to $3,000 per year, with a 100 percent employer match up to 3 percent of the employee's compensation. No nondiscrimination rules would apply to PRIME accounts. An employer could maintain PRIME accounts or SEPs for its employees, but not both.

Only employers who normally employ fewer than 100 employees and who do not maintain a qualified plan could establish PRIME accounts for their employees. All employees of the employer who are reasonably expected to work at least 1,200 hours during the year would be eligible to participate in the PRIME account. All contributions to an employee's PRIME account would be fully vested. Simplified reporting requirements would apply.

Effective Date

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

2. Repeal of limitation on ability of tax-exempt employers to maintain cash or deferred arrangements

Description of Proposal

The proposal would permit tax-exempt organizations other than State or local governments (including Indian tribes) to maintain qualified cash or deferred arrangements for its employees.

Effective Date

Years beginning after December 31, 1992.

3. Duties of master and prototype plan sponsors

Description of Proposal

The proposal would authorize the IRS to define the

duties of organizations that sponsor master and prototype, regional prototype, and other preapproved plans. The proposal would also provide that the Secretary could relax the rules prohibiting cutbacks in accrued benefits when an employer replaces an individually designed plan with a preapproved plan.

<u>Effective Date</u>

The proposal would be effective January 1, 1993.

C. Nondiscrimination Provisions

1. Modification to definition of leased employee

<u>Description of Proposal</u>

The proposal would replace the "historically performed" test with a new rule defining who must be considered a leased employee. Under the proposal, an individual would not be considered a leased employee unless the services are performed under the control of the service recipient.

<u>Effective Date</u>

Years beginning after December 31, 1983. In those specific situations where the Internal Revenue Service has ruled that service relationships do not involve "leased employees" under the test of present law requiring the services to be of a type historically performed in the business field of the recipient by employees, the recipients of those rulings may continue to rely on them.

2. Definition of highly compensated employee and family aggregation rules

<u>Description of Proposal</u>

The proposal would provide that an employee is highly compensated if the employee (1) was a 5-percent owner during the year or the preceding year, or (2) had compensation for the preceding year in excess of the compensation limit for the preceding year. The compensation limit would be $50,000 (indexed). As under present law, the dollar limit in effect for 1992 would be $62,345. If no employee is treated as highly compensated under this rule, the highest paid officer would be treated as highly compensated except (1) for purposes of applying the nondiscrimination requirements applicable to qualified cash or deferred arrangements (sec. 401(k)) and employer matching and after-tax employee contributions (sec. 401(m)), and (2) for plans maintained by State and local governments and tax-exempt organizations.

The proposal would repeal the present-law rule that

provides that certain family members are aggregated and treated as a single highly compensated employee.

Effective Date

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

3. Simplification of nondiscrimination tests relating to qualified cash or deferred arrangements, matching contributions, and after-tax employee contributions

Description of Proposal

a. Qualified cash or deferred arrangements

The proposal would add an alternative safe harbor method of satisfying the special nondiscrimination test for qualified cash or deferred arrangements. Under the proposal, the nondiscrimination test would be deemed to be satisfied if the employer either (1) makes a nonincreasing matching contribution on behalf of each nonhighly compensated employee of at least (a) 100 percent of the employee's elective contributions up to 3 percent of compensation and (b) 50 percent of the employee's elective contributions up to 6 percent of compensation, or (2) makes a nonelective contribution to a defined contribution plan of at least 3 percent of each nonhighly compensated employee's compensation, without regard to whether the employee elects to contribute to the cash or deferred arrangement.

The matching contributions and the nonelective contributions would be required to be 100-percent vested. In addition, the employer would be required to notify employees of the employees' rights and obligations under the arrangement.

In applying the present-law nondiscrimination test, the amount that highly compensated employees can defer in a year would be based on the previous year's average deferral percentage (ADP) for nonhighly compensated employees. A special rule would apply in the first year a cash or deferred arrangement is maintained. A corresponding change would be made to the nondiscrimination test applicable to employer matching and after-tax employee contributions.

The proposal would also modify the method of determining excess contributions under the present-law nondiscrimination test. Under the proposal, excess contributions would be allocated among highly compensated employees beginning with the employees with the highest dollar amount of contributions.

b. Employer matching contributions

Under the proposal, the special nondiscrimination test for employer matching contributions (but not for after-tax employee contributions) would be deemed satisfied if (1) the plan meets the nonelective contribution or matching contribution requirements applicable to the cash or deferred arrangement safe harbor, (2) employees are notified of the plan, (3) matching contributions are not made with respect to employee contributions of elective deferrals in excess of 6 percent of compensation, and (4) the level of an employer's matching contribution does not increase as employee's contributions or elective deferrals increase.

Effective Date

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

4. Modification of additional participation requirements

Description of Proposal

The proposal would provide that the minimum participation rule (sec. 401(a)(26)) applies only to defined benefit plans (not defined contribution plans). Under the proposal, a plan would not be a qualified plan unless the plan, on each day of the plan year, benefits no fewer than the lesser of 25 employees or 40 percent of all employees of the employer. However, a plan maintained by an employer with only 2 employees would be required to cover both.

For purposes of the rule that permits the minimum participation requirement to be satisfied separately with respect to each line of business of an employer, an employer could demonstrate that a separate line of business exists even if that line of business employs less than 50 employees.

Effective Date

The proposal would apply to years beginning after December 31, 1991. An employer could elect to apply the provision modifying the minimum participation rule as if included in the Tax Reform Act of 1986.

5. Election to treat base pay as compensation

Description of Proposal

The proposal would provide that an employer may elect to define compensation as an employee's base pay. This election would be required to apply to all employees of the employer, and could be revoked only with permission of the Secretary.

Effective Date

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

6. Uniform retirement age

Description of Proposal

Provide that, for purposes of the general nondiscrimination rule (sec. 401(a)(4)), the social security retirement age (as defined under sec. 415(b)(8)) is treated as a uniform retirement age, and that subsidized early retirement benefits and joint and survivor annuities that are based on social security retirement age are treated as being available on the same terms.

Effective Date

Years beginning after December 31, 1992.

D. Miscellaneous Pension Simplification

1. Cost-of-living adjustments

Description of Proposal

The proposal would provide that the adjustments with respect to a year are based on the increase in the applicable index as of the close of the calendar quarter ending September 30 of the preceding year. Thus, adjusted dollar limits would be published before the beginning of the year to which they apply. Also, dollar limits would generally be rounded to the nearest $1,000, except that the limits that relate to elective deferrals and elective contributions to a simplified employee pension plan (SEP) would be rounded to the nearest $100.

Effective Date

The proposal would apply to years beginning after December 31, 1992.

2. Half-year requirements

Description of Proposal

The proposal would change age 70-1/2 to age 70, and age 59-1/2 to age 59 for purposes of the qualified plan rules.

Effective Date

Years beginning after December 31, 1992.

3. Plans for self-employed individuals

Description of Proposal

The proposal would eliminates the special aggregation rule for plans maintained by self-employed individuals.

Effective Date

Years beginning after December 31, 1992.

4. Contributions on behalf of disabled employees

Description of Proposal

Under present law, an employer may elect to continue making contributions on behalf of employees other than highly compensated employees who become disabled. The proposal would extend extends present-law treatment to disabled highly compensated employees if continuing contributions to the plan are available to all disabled participants. The employer would not be required to make an election to have the special rule apply.

Effective Date

Years beginning after December 31, 1992.

5. Affiliation requirements for employers jointly maintaining a voluntary employees' beneficiary association (VEBAs)

Description of Proposal

The proposal would provide that employers are affiliated for purposes of the VEBA requirements under Treasury regulations if (1) the employers are in the same line of business, (2) the employers act jointly to perform tasks that are integral to the activities of each of the employers, (3) these joint activities are sufficiently extensive that maintenance of a common VEBA is not a major part of such joint activity, and a substantial number of the employers who contribute to the VEBA are exempt from tax under the Internal Revenue Code.

Effective Date

The provision is intended to be a clarification of present law, and would apply to years beginning before, on, or after the date of enactment.

6. In-service distributions from rural cooperative plans

Description of Proposal

The proposal would conform the rules for distributions from cash or deferred arrangements maintained by rural cooperatives to the rules applicable to other cash or deferred arrangements by permitting distributions after the attainment of age 59-1/2.[2]

Effective Date

Effective as if included in section 1011(k)(9) of the Technical and Miscellaneous Revenue Act of 1988.

7. Inclusion of union employees for coverage testing

Description of Proposal

Provide that employers may elect to take employees covered by a collective bargaining agreement into account in applying the coverage tests to a nonunion plan (sec. 410(6)), in applying the general nondiscrimination rule to a nonunion plan (sec. 401(a)(4)), and in determining separate lines of business (sec. 414(a)) if the union employees benefit under the same plan on the same terms.

Effective Date

Years beginning after December 31, 1992.

8. Use of excess assets of black lung benefit trusts for retire health care benefits

Description of Proposal

Allow excess assets in qualified black lung benefit trusts to be used to pay accident and health benefits or premiums for insurance for such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents. The amount of assets available for such purpose would be subject to a yearly limit as well as an aggregate limit. The yearly limit would be the amount of assets in excess of 110 percent of the present value of the liability for black lung benefits determined as of the close of the preceding taxable year of the trust. The aggregate limit would be the amount of assets in excess of 110 percent of the present value of the liability for black lung benefits

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[2] Age 59-1/2 would be changed to age 59 under another provision of the bill, described above.

determined as of the close of the taxable year of the trust ending prior to the effective date, plus earnings thereon. Each of these determinations would be required to be made by an independent actuary.

The amounts used to pay retiree accident or health benefits would not be includible in the income of the company, nor would a deduction be allowed for such amounts.

Effective Date

Taxable years beginning after December 31, 1991.

9. Full-funding limitation of multiemployer plans

Description of Proposal

The proposal would provides that multiemployer plans are not subject to the 150 percent of current liability full funding limitation under the Internal Revenue Code and that an actuarial valuation need only be performed every 3 years in the case of a multiemployer plan.

Effective Date

Years beginning after December 31, 1991.

10. Special coverage rule for airline pilots

Description of Proposal

Extend the present-law treatment of plans maintained for union pilots to plans maintained for nonunion pilots who are employed by one or more common carriers or by carriers transporting mail for, or under contract with, the United States Government.

Effective Date

Years beginning after December 31, 1992.

11. Alternative full funding limitation

Description of Proposal

The provision would provide that an employer may elect to disregard the 150 percent of current liability full funding limitation if each plan in the employer's controlled group is not top heavy and the average accrued liability of active participants is at least 80 percent of the plan's total accrued liability (the "alternative full funding limitation"). The Secretary would be required to adjust the 150 percent of current liability full funding limitation (but not below 140 percent) for employers that do not use the

alternative full funding limit to ensure that the election by employers to disregard the 150-percent limit does not result in a substantial reduction in Federal revenues for any fiscal year.

Employers electing to apply the alternative limitation must notify the Secretary by January 1 of the calendar year preceding the calendar year in which the election period begins. In the case of any election period beginning on or after July 1, 1992, and before January 1, 1994, the notice requirement is deemed satisfied if the Secretary is notified of the election by October 31, 1992. In addition, the Secretary is required, by January 1, 1993, to notify defined benefit plans that have not made an election to apply the alternative limitation of any adjustment to the 150-percent full funding limitation required under the provision.

To the extent a defined benefit plan sponsor makes a contribution to a defined benefit plan with respect to the election period that exceeds the full-funding limitation, as adjusted by the Secretary for the transition period, the sponsor is required to offset the excess contribution against allowable contributions to the plan in subsequent quarters in the taxable year of the sponsor. If no subsequent contributions may be made for the taxable year, the trustee of the plan must return the excess contribution to the sponsor in that taxable year or the subsequent taxable year.

<u>Effective Date</u>

The provision would be effective on the date of enactment.

12. Establish commission on retirement income policy

<u>Description of Proposal</u>

Establish a commission to study national retirement income policy. The commission would be directed to submit a report to the Congress by Labor Day 1994, the 20th anniversary of the enactment of the Employee Retirement Income Security Act of 1974.

<u>Effective Date</u>

Date of enactment.

13. Date for adoption of plan amendments

<u>Description of Proposal</u>

The proposal would provide that if any provision of the bill requires a plan amendment, the amendment is not required to be made before the first plan year beginning on or after

January 1, 1995, if (1) during the period after the provision takes effect, the plan is operated in accordance with the requirements of the provision, and (2) the plan amendment applies retroactively to the provision's effective date.

Effective Date

Date of enactment.

14. Modification to limits on contributions and benefits for governmental plans

Description of Proposal

The proposal would make a number of modifications to the limits on contributions and benefits as applied to plans maintained by State and local governments. The proposal would exempt participants of State and local government defined benefit plans from the 100 percent of high 3-year average compensation limitation. Also, benefits provided under a "qualified excess benefit arrangement" (which is treated as a nonqualified deferred compensation plan for tax purposes) would not be taken into account for purposes of applying the limits on contributions and benefits. Survivor and disability benefits provided under State and local government plans would also be exempt from the limits on contributions and benefits.

The proposal would provide that for purposes of the limits on contributions and benefits, the compensation of participants in such plans includes, in addition to the usual amounts, amounts contributed pursuant to a salary reduction agreement that are not includible in the participant's income.

Under the proposal, governmental plans would be treated as satisfying the limits on contributions and benefits for all taxable years beginning before the date of enactment.

Effective Date

Taxable years beginning after date of enactment.

15. Coordinated deferral limit under deferred compensation plans of State and local governments and tax-exempt organizations

Present Law

Under present law, the limit on elective deferrals to a qualified cash-or-deferred arrangement (sec. 401(k)), tax-deferred annuity plan (sec. 403(b)), or simplified employee pension (SEP) (sec. 408(k)) is $8,728 (indexed). The limit on contributions to a deferred compensation plan of

State and local governments and tax-exempt organizations (sec. 457) generally is $7,500 (not indexed).

In addition, section 457 provides a coordinated contribution limit under which contributions to a 401(k) plan, 403(b) annuity, or SEP are treated as 457 contributions for purposes of the 457 limit, so that the sum of contributions to all such plans is limited to $7,500 (fixed). Thus, an individual that participates, for example, in both a 457 plan and a 401(k) plan may contribute no more than a total of $7,500 to both plans. However, an individual who participates only in a 401(k) plan may contribute up to $8,728 to such plan.

Description of Proposal

The proposal would provide that an individual who participates in both a 457 plan and a 401(k) plan, 403(b) annuity or SEP may contribute no more than a total of $8,728 (indexed) to both plans. However, contributions to the 457 plan still could not exceed $7,500, as under present law.

Effective Date

The proposal would be effective for years beginning after December 31, 1992.

16. Church pension plans

Present Law

Plans maintained by churches and certain church-controlled organizations are exempt from certain of the qualification requirements applicable to pension plans under the Code pursuant to the Employee Retirement Income Security Act of 1974 (as amended) (ERISA). For example, such plans are not subject to ERISA's vesting, coverage, and funding requirements. Church plans may elect to waive the exemption from the qualification rules.

Description of Proposal

The proposal would provide that church plans that are subject to pre-ERISA vesting rules under present law would be subject to ERISA's vesting rules in effect immediately before the enactment of the Tax Reform Act of 1986. Thus, benefits under such plans would be required to vest at least as rapidly as under a 10-year cliff vesting schedule, or under a schedule that provides ratable vesting between 5 and 15 years of service.

In the case of a church plan maintained by more than one employer, if one or more organizations maintaining a church plan fails to satisfy the qualification requirements, the plan is not disqualified with respect to the other organizations maintaining the plan that meet such requirements.

The proposal would modify the definition of highly compensated employee applicable to church plans by providing that a person is not considered an officer, shareholder, or person whose principal duties consist of supervising the work of other employee if the employee receives less than $50,000 of compensation (indexed). In addition, certain employees covered by a collective bargaining agreement (sec. 410(b)(3)(A)) would be excluded.

Tax-sheltered annuity contracts (sec. 403(b)) are permitted to make distributions on account of hardship. The proposal would modify the definition of hardship so that it is the same as that used for purposes of the rule relating to cash or deferred arrangements (sec. 401(k)(2)).

The proposal would permit self-employed ministers to participate in the denominational church plan. Such ministers would be disregarded in applying applicable nondiscrimination rules.

The proposal would require that church plans do not have to maintain separate accounts under a section 401(h) account for employees who are key employees merely because they are

officers with annual compensation greater than a certain amount. Any benefits provided under the account would, however, have to be taken into account for purposes of the limits on contributions and benefits as under present law.

The proposal modify the elective catch-up provision relating to section 403(b) annuities and retirement income accounts maintained by churches by repealing the limitation on the amount of such catch-up contributions based on years of service (sec. 402(g)(8)(A)(iii)).

The proposal would modify the minimum distribution rules (sec. 401(a)(9)) to permit church plans to pay a benefit at year-end (the so-called "13th check") or to provide an annuity which increases slightly each year.

The proposal would expand the present-law exception to the age 70-1/2 rule for church plans so that it applies to church plans as defined in section 414(e).

Effective Date

The vesting proposal would be effective for years beginning after December 31, 1993. The proposals relating to plans maintained by more than one employer, the definition of highly compensated employee, self-employed ministers, and the forms of benefits under the minimum distribution rules would be effective for years beginning on, after, or before December 31, 1991. The proposal relating to the definition of disability would be effective for years beginning after December 31, 1988. The proposal relating to section 401(h) accounts would be effective for years beginning after March 31, 1984. The proposal relating to catch-up contributions and the age 70-1/2 rule would be effective as if included in the provision of the Tax Reform Act of 1986 to which such proposal relates.

Subpart B. Income Tax Provisions

A. Individual Tax Provisions

1. Rollover of gain on sale of principal residence

Present Law

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of section 1034.

The determination whether property is used by a taxpayer as a principal residence depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. No safe harbor is provided for sales of principal residences incident to divorce or marital separation.

Description of Proposal

The proposal provides a safe harbor in the determination of principal residence in certain cases incident to divorce or marital separation. Specifically, the bill provides that a residence is treated as the taxpayer's principal residence at the time of sale if (1) the residence is sold pursuant to a divorce or marital separation and (2) the taxpayer used such residence as his or her principal residence at any time during the two-year period ending on the date of sale.

Effective Date

The proposal applies to sales of old residences (within the meaning of section 1034) after the date of enactment.

2. Permit payment of taxes by credit card

Present Law

Payment of taxes may be made by checks or money orders, to the extent and under the conditions provided by regulations.

Description of Proposal

The proposal permits payment of taxes by credit card, to the extent and under the conditions provided by regulations.

Effective Date

The proposal is effective on the date of enactment.

3. Election by parent to claim unearned income of certain children on parent's return

Present Law

The net unearned income of a child under 14 years of age is taxed to the child at the parents' statutory rate. Net unearned income means unearned income less the sum of $600 and the greater of: (1) $600 or, (2) if the child itemizes deductions, the amount of allowable deductions directly connected with the production of the unearned income. The dollar amounts are adjusted for inflation.

In certain circumstances, a parent may elect to include a child's unearned income on the parent's income tax return if the child's income is less than $5,000. A parent making this election must include the gross income of the child in excess of $1,000 in income for the taxable year. In addition, the parent must report an additional tax liability equal to the lesser of (1) $75 or (2) 15 percent of the excess of the child's income over $500. The dollar amounts for the election are not adjusted for inflation.

A person claimed as a dependent cannot claim a standard deduction exceeding the greater of $600 or such person's earned income. For alternative minimum tax purposes, the exemption of a child under 14 years of age generally cannot exceed the sum of such child's earned income plus $1,000. The $600 amount is adjusted for inflation but the $1,000 amount is not.

Description of Proposal

The proposal adjusts for inflation the dollar amounts involved in the election to claim unearned income on the parent's return. It likewise indexes the $1,000 amount used in computing the child's alternative minimum tax.

Effective Date

The proposal applies to taxable years beginning after December 31, 1991.

4. Simplified foreign tax credit limitation for individuals

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit

limitation categories. In the case of an individual, this requires the filing of IRS Form 1116, designed to elicit sufficient information to perform the necessary calculations.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments (e.g., dividends from a foreign corporation subject to foreign withholding taxes or dividends from a domestic mutual fund that can pass through its foreign taxes to the shareholder (see sec. 853)). Taxable income of this type ordinarily is subject to the single foreign tax credit limitation category known as passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in several other separate limitation categories (e.g., high withholding tax interest income, general limitation income) designed to accomplish certain policy objectives or forestall certain abuses. For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Description of Proposal

The proposal allows individuals with no more than $200 of creditable foreign taxes, and no foreign source income other than income that is in the passive basket, to elect a simplified foreign tax credit limitation equal to the lesser of 25 percent of the individual's foreign source gross income or the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year. (It is intended that an individual electing this simplified limitation calculation not be required to file Form 1116 in order to obtain the benefit of the credit.) A person who elects the simplified foreign tax credit limitation is not allowed a credit for any foreign tax not shown on a payee statement (as that term is defined in sec. 6724(d)(2)) furnished to him or her. Nor is the person entitled to treat any excess credits for a taxable year to which the election applied as a carryover to another taxable year. Because the limitation for a taxable year to which the election applies can be no more than the creditable foreign taxes actually paid for the taxable year, it is also the case under the proposal that no excess credits from another year can be carried over to the taxable year to which the election applies.

For purposes of the simplified limitation, passive income generally is defined to include all types of income that would be foreign personal holding company income under the subpart F rules, plus income inclusions from passive foreign corporations (as defined by the proposal), so long as the income is shown on a payee statement furnished to the

individual. Thus, for purposes of the simplified limitation, passive income includes all dividends, interest (and income equivalent to interest), royalties, rents, and annuities; net gains from dispositions of property giving rise to such income; net gains from certain commodities transactions; and net gains from foreign currency transactions that give rise to foreign currency gains and losses as defined in section 988. The statutory exceptions to treating these types of income as passive for foreign tax credit limitation purposes, such as the exceptions for high-taxed income and high-withholding-tax interest, are not applicable in determining eligibility to use the simplified limitation.

Although an estate or trust generally computes taxable income and credits in the same manner as in the case of an individual (Code sec. 641(b); Treas. Reg. sec. 1.641(b)-1), the simplified limitation does not apply to an estate or trust.

Effective Date

The proposal applies to taxable years beginning after December 31, 1991.

5. Personal transactions by individuals in foreign currency

Present Law

When a U.S. taxpayer with a U.S. dollar functional currency makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss can also arise where foreign currency was acquired for personal use. For example, the IRS has ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use--while traveling abroad--realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency (Rev. Rul. 74-7, 1974-1 C.B. 198).

Prior to the Tax Reform Act of 1986 (the "1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the Internal Revenue Service ("IRS"). Additional rules of limited application were provided by Treasury regulations and, in a

few instances, statutory bills. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The result of prior law was uncertainty of tax treatment for many legitimate transactions, as well as opportunities for tax-motivated transactions. Therefore, in 1986 Congress determined that a comprehensive set of rules should be provided for the U.S. tax treatment of transactions involving "nonfunctional currencies;" that is, currencies other than the taxpayer's "functional currency."

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection, or refund of taxes). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.

Description of Proposal

In a case where an individual acquires nonfunctional currency and then disposes of it in a personal transaction, and where exchange rates have changed in the intervening period, the proposal provides for nonrecognition of an individual's resulting exchange gain not exceeding $200. The proposal does not change the treatment of resulting exchange losses. It is understood that under other Code provisions, such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The proposal applies to taxable years beginning after December 31, 1991.

6. Make income tax withholding rules parallel to rules for exclusion from income for combat pay

Present Law

Exclusion for combat pay

Gross income does not include certain combat pay of members of the Armed Forces (sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income (special rules apply if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone). In the case of commissioned

officers, these exclusions from income are limited to $500 per month of military pay.

Income tax withholding

There is no income tax withholding with respect to military pay for a month in which a member of the Armed Forces of the United States is entitled to the benefits of section 112 (sec. 3401(a)(2)). With respect to enlisted personnel, this income tax withholding rule parallels the exclusion from income under section 112: there is total exemption from income tax withholding and total exclusion from income. With respect to officers, however, the withholding rule is not parallel: there is total exemption from income tax withholding, although the exclusion from income is limited to $500 per month.

Description of Proposal

The proposal makes the income tax withholding exemption rules parallel to the rules providing an exclusion from income for combat pay.

Effective Date

The proposal is effective as of January 1, 1994.

7. Expanded access to simplified income tax returns

Present Law

There are three principal tax forms that are utilized by individual taxpayers: Form 1040EZ, Form 1040A, and Form 1040.

Description of Proposal

The proposal provides that the Secretary of the Treasury (or his delegate) shall take such actions as may be appropriate to expand access to simplified individual income tax forms and otherwise to simplify the individual income tax returns.

The proposal also requires that the Secretary submit a report to the Congress on the actions undertaken pursuant to this bill, together with any recommendations he may deem advisable.

Effective Date

The report is due no later than one year after the date of enactment.

8. Simplification of tax treatment of rural letter carriers' vehicle expenses

Present Law

A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and maintenance expenses of the vehicle, plus depreciation (subject to the limitations of sec. 280F). If the taxpayer is an employee and these expenses are not reimbursed, the deduction is subject to the two-percent floor. Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

An employee of the U.S. Postal Service may compute his or her deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route by using, for all business use mileage, 150 percent of the standard mileage rate.

Description of Proposal

The proposal repeals the special rate of 150 percent of the standard mileage rate. In its place, the bill provides that the rate of reimbursement provided by the Postal Service to rural letter carriers is considered to be equivalent to their expenses. The rate of reimbursement that is considered to be equivalent to their expenses is the rate of reimbursement contained in the 1991 collective bargaining agreement, which may in the future be increased by no more than the rate of inflation.

Effective Date

The proposal is effective for taxable years beginning after December 31, 1991.

9. Exemption from luxury excise tax for certain equipment installed on passenger vehicles for use by disabled individuals

Present Law

The Code imposes a 10-percent excise tax on the portion of the retail price of a passenger vehicle that exceeds $30,000. The tax also applies to separate purchases of component parts and accessories occurring within six months of the date the vehicle is placed in service.

Description of Proposal

The proposal provides that the luxury excise tax does

not apply to a part or accessory installed on a passenger vehicle to enable or assist an individual with a disability to operate the vehicle, or to enter or exit the vehicle, in order to compensate for the effect of the disability.

Persons entitled to a refund may obtain it through the dealer at which they purchased the taxed item, as provided under present-law Code section 6416.

Effective Date

The proposal is effective for purchases after December 31, 1990.

10. Simplification of earned income tax credit

Present Law

Eligible low-income workers are able to claim a refundable earned income tax credit (EITC) of up to 17.6 percent of the first $7,520 of earned income for 1992 (18.4 percent for taxpayers with more than one qualifying child). The maximum amount of credit for 1992 is $1,324 ($1,384 for taxpayers with more than one qualifying child). This maximum credit is reduced by 12.57 percent of earned income (or adjusted gross income, if greater) in excess of $11,840 (the phase-out rate is 13.14 percent for taxpayers with more than one qualifying child). The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $22,370. The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

	One qualifying child--		Two or more qualifying children--	
Year	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6	12.57	18.4	13.14
1993	18.5	13.21	19.5	13.93
1994 and after	23.0	16.43	25.0	17.86

A supplemental young child credit is available to taxpayers with qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same income base as the ordinary EITC. The maximum supplemental young child credit for 1992 is $376. If a taxpayer claims the supplemental young child credit, the child that qualifies the taxpayer for such credit is not a qualifying individual for purposes of the dependent care tax credit (sec. 21).

A supplemental health insurance credit is available to taxpayers who provide health insurance coverage for their qualifying children. This health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. It is computed on the same income base as the ordinary EITC, but the credit claimed cannot exceed the out-of-pocket cost of the health insurance coverage. In addition, the taxpayer is denied an itemized deduction for medical expenses of qualifying insurance coverage up to the amount of credit claimed. The maximum supplemental health insurance credit for 1992 is $451.

Explanation of Proposal

The proposal would permit taxpayers to include all health insurance expenses as medical expenses, subject to the 7.5 percent of adjusted gross income floor on deductible medical expenses, regardless of whether these expenses had been used to claim the health insurance component of the EITC. The proposal also would permit a self-employed taxpayer to claim the allowable deduction for health insurance costs and to use the full amount of these expenses that are related to coverage of dependent children to claim the health insurance component of the EITC.

The proposal also would permit taxpayers to claim the dependent care credit for expenses related to care of the child that qualifies the taxpayer for the supplemental young child credit.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1991.

11. Rollover of gain on sale of principal residence in the case of frozen deposits

Present Law

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of section 1034. The determination whether property is used by a taxpayer as a principal residence depends upon all the facts and circumstances in each case.

Description of Proposal

The proposal would suspend the running of the two-year period after the date of sale of the old residence (referred to in sec. 1034(a) and (c) other than (c)(4)) during any time that the taxpayer has frozen deposits during the two-year period beginning on the date of sale of the old residence. The period as suspended would not extend beyond the date that is four years after the date of sale of the old residence. A taxpayer would be treated as having frozen deposits if the taxpayer's deposit in a financial institution may not be withdrawn due to: (1) the bankruptcy or insolvency of the financial institution or, (2) any requirement imposed by the State in which the financial institution is located by reason of the bankruptcy or insolvency (or threat thereof) of one or more financial institutions located in the State.

Effective Date

The provision would apply to any residence sold or exchanged after December 31, 1990, and any residence sold or exchanged before that date if the two-year period had not expired before January 1, 1991.

B. Accounting Provisions

1. Modifications to the look-back method for long-term contracts

Present Law

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

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[1] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

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

The look-back method does not apply to any contract that

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[1] The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use five different interest rates.

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

Description of Proposal

Election not to apply the look-back method for de minimis amounts

The proposal would provide that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but would not be required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year.

The election would apply to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Election not to re-apply the look-back method

The proposal would also provide that a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract would not be discounted.

Thus, an electing taxpayer would need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis.

The election would apply to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Determination of interest rate

Finally, the proposal would provide that for purposes of the look-back method, only one rate of interest is to apply for each accrual period. An accrual period with respect to a taxable year would begin on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest would be the overpayment rate in effect for the calendar quarter in which the accrual period begins.

Effective Date

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

2. Simplified method for applying uniform cost capitalization rules

Present Law

In general, the uniform cost capitalization rules require taxpayers that are engaged in the production of real or tangible personal property or in the purchase and holding of property for resale to capitalize or include in inventory the direct costs of the property and the indirect costs that are allocable to the property. In determining whether indirect costs are allocable to production or resale activities, taxpayers are allowed to use various methods so long as the method employed reasonably allocates indirect costs to production and resale activities.

Description of Proposal

The proposal would authorize (but would not require) the Treasury Department to issue regulations that allow taxpayers in appropriate circumstances to determine the costs of any administrative, service, or support function or department that are allocable to production or resale activities by multiplying the total amount of costs of any such function or department by a fraction, the numerator of which is the amount of costs of the function or department that was allocable to production or resale activities for a base

period and the denominator of which is the total amount of costs of the function or department for the base period. It is anticipated that the regulations would provide that the base period is to begin no earlier than 4 taxable years prior to the taxable year with respect to which this simplified method applies.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment. Thus, the regulations may permit the use of the simplified method for taxable years beginning after this date. The simplified method, however, would not be used for any taxable year that begins prior to the date that the Treasury Department publishes regulations that authorize the use of the simplified method and set forth the requirements that must be satisfied in order for the method to be used.

3. Treatment of certain amounts received by operators of licensed cotton warehouses

Present Law

A C corporation (other than a farm corporation) generally may not use the cash method of accounting if the corporation had average annual gross receipts for the 3-year period ending with the prior taxable year of more than $5,000,000. Corporations that are denied the use of the cash method of accounting generally must use an accrual method of accounting.

Description of Proposal

Income recognition

The proposal would allow the election of a special rule in the case of any taxpayer that is an operator of a licensed cotton warehouse and uses an accrual method of accounting to compute taxable income. Under the election, the taxpayer would not be required to accrue amounts to be received for processing or storing cotton at the licensed cotton warehouse until such amounts are actually received. For this purpose, the term "licensed cotton warehouse" would mean any warehouse for the storage of cotton that is licensed under the United States Warehouse Act (7 U.S.C 241, et seq.) or under any similar State law.

Interest charge

In addition, under the election, if any deferred amount is received during any taxable year, the tax liability of the taxpayer for the taxable year would be increased by an interest charge with respect to the deferred amount. The interest charge with respect to any deferred amount would be determined: (1) on the amount of the tax for such taxable year which is attributable to the deferred amount; (2) for the period beginning on the due date for the taxable year of the deferral and ending on the due date for the taxable year in which such deferred amount is received; (3) and by using the Federal short-term rate in effect under section 1274 as of the due date for the taxable year in which such deferred amount is received (compounded semiannually).

The term "deferred amount" would mean any amount that is includible in gross income for the taxable year but that would have been under includible in gross income for a prior taxable year but for this proposal. The "taxable year of deferral" would be the taxable year for which the deferred amount would have been includible in gross income but for this proposal. The term "due date" would mean the date prescribed for filing the return of tax (without regard to extensions) for the taxable year.

The interest charge payable would be taken into account in computing the amount of any deduction allowable as interest paid or accrued during the taxable year that the interest charge is payable. In addition, the interest charge would not be treated as a tax for purposes of determining the taxpayer's regular tax liability under section 26.

Election

The proposal would apply to a taxpayer only if the taxpayer makes an election to apply the proposal. The election would be required to be made in a time and manner prescribed by the Secretary of the Treasury. If made, the election would apply to the taxable year for which made and all subsequent years unless revoked with the consent of the Secretary.

Effective Date

The proposal would apply to amounts accrued in taxable years beginning after December 31, 1991.

C. Subchapter S Corporation Provisions

1. Determination of whether an S corporation has one class of stock

Present Law

Under present law, a small business corporation eligible to be an S corporation may not have more than one class of stock. Differences in voting rights are disregarded in determining whether a corporation has more than one class of stock. In addition, certain debt instruments may not be treated as a second class of stock for purposes of this rule.

On October 5, 1990, the Treasury Department issued proposed regulations providing that a corporation has more than one class of stock if all of the outstanding shares of stock do not confer identical rights to distribution and liquidation proceeds, regardless of whether any differences in rights occur pursuant to the corporate charter, articles or bylaws, by operation of State law, by administrative action, or by agreement. The proposed regulations also provided that, notwithstanding that all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation has more than one class of stock if the corporation makes non-conforming distributions (i.e., distributions that differ with respect to timing or amount with respect to each share of stock), with limited exceptions for certain redemptions and certain differences in the timing of distributions. The proposed regulations were to apply to taxable years beginning after December 31, 1982.

On August 8, 1991, the Treasury Department issued revised proposed regulations replacing the proposed regulations described above. The regulations were issued as final regulations on May 29, 1992 (Treasury Decision 8419). These regulations provide that a corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Under the revised regulations, any distributions that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances. These regulations generally apply to taxable years beginning after May 28, 1992.

Description of Proposal

The proposal provides that a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Applicable State law, taking into account legally enforceable rights under the corporate charter, articles or bylaws, administrative action, and agreements relating to distributions or liquidation

proceeds with respect to shares, determines whether the outstanding shares confer different rights to distributions or liquidation proceeds.

Where an S corporation in fact makes distributions which differ as to timing or amount, the bill in no way limits the Internal Revenue Service from properly characterizing the transaction for tax purposes. For example, if a distribution is properly characterized as compensation, the Service could require it to be so treated for tax purposes. Similarly, if a payment appearing as compensation should be properly characterized as a distribution, the Service could require it to be so treated for purposes of computing taxable income.

Effective Date

The proposal applies to taxable years beginning after December 31, 1982.

2. Authority to validate certain invalid elections

Present Law

Under present law, if the Internal Revenue Service determines that a corporation's Subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Present law does not grant the Internal Revenue Service the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The Internal Revenue Service may not validate a late election.

Description of Proposal

Under the proposal, the authority of the Internal Revenue Service to waive the effect of an inadvertent termination is extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both. It is intended that the Internal Revenue Service be reasonable in granting waivers of inadvertent invalid elections so that a corporation whose election was inadvertently invalid would be treated as an S corporation as if the election had been effective.

The proposal also allows the Internal Revenue Service to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely. It is intended that the Internal Revenue Service adopt a standard similar to the standard currently set forth in Treasury regulation sec. 1.9100-1 in applying this provision.

Effective Date

The proposal applies to taxable years beginning after December 31, 1982.

3. **Treatment of distributions by S corporations during loss year**

Present Law

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of the stock.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules appear to require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.

In addition, if the S corporation has accumulated earnings and profits, any distribution in excess of the amount in an "accumulated adjustments account" will be

treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

Description of Proposal

The proposal provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The proposal also provides that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

Effective Date

These proposals apply to distributions made in taxable years beginning after December 31, 1991.

4. Treatment of S corporations as shareholders in C corporations

Present Law

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C

corporation may merge into an S corporation tax-free.

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). The Internal Revenue Service has taken the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder. Thus, a C corporation may elect S corporation status tax-free or may merge into an S corporation tax-free, but may not liquidate into an S corporation tax-free. Also, the Service's reasoning would also prevent an S corporation from making an election under section 338 where a C corporation was acquired by an S corporation.

Description of Proposal

The proposal repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation will also be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule does not change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

No inference is intended regarding the present-law treatment of these transactions.

Effective Date

The proposal applies to taxable years beginning after December 31, 1991.

5. S corporations permitted to hold subsidiaries

Present Law

Under present law, an S corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). The legislative history indicates that this rule was adopted to prevent the filing of consolidated returns by a group which includes an S corporation.

Description of Proposal

The proposal repeals the rule that an S corporation may not be a member of an affiliated group of corporations. Thus, an S corporation will be allowed to own up to 100 percent of the stock of a C corporation. However, an S corporation cannot be included in a group filing a consolidated return.

Under the proposal, if an S corporation holds 100 percent of the stock of a C corporation that, in turn, holds 100 percent of the stock of another C corporation, the two C corporations may elect to file a consolidated return (if otherwise eligible), but the S corporation may not join in the election.

Effective Date

The proposal applies to taxable years beginning after December 31, 1991.

6. Elimination of pre-1983 earnings and profits of S corporations

Present Law

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. As a result of this rule, a shareholder may later be required to include in his income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Description of Proposal

The proposal provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1991, the accumulated earnings and profits of the corporation as of the beginning of that year are reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits will be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his share of the taxable income of the S corporation.

Effective Date

The proposal applies to taxable years beginning after December 31, 1991.

7. Treatment of items of income in respect of a decedent held by an S corporation

Present Law

Income in respect of a decedent (IRD) generally consists of items of gross income that accrued during the decedent's lifetime but were not yet includible in the decedent's income before his death under his method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for the estate tax attributable to an item of IRD is allowed to the person who includes the item in gross income (sec. 691(c)).

The cost or basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis often is referred to as a "stepped-up basis". Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD. Although S corporation income is included in the income of the shareholders in a manner similar to the inclusion of partnership income in the income of the partners, no comparable regulation provides for a reduction in the basis of stock of an S corporation acquired from a decedent where

the S corporation holds items of IRD on the date of death of a shareholder. Thus, under present law, the treatment of an item of IRD held by an S corporation is unclear.

Description of Proposal

The proposal provides that a person acquiring stock in an S corporation from a decedent will treat as IRD his pro rata share of any item of income of the corporation which would have been IRD if that item had been acquired directly from the decedent. Where a item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed under the provisions of section 691(c). The stepped-up basis in the stock will be reduced by the extent to which the value of the stock is attributable to items consisting of IRD. This basis rule is comparable to the present-law partnership rule.

No inference is intended regarding the present-law treatment of IRD in the case of S corporations.

Effective Date

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

8. Certain trusts eligible to hold stock in an S corporation

Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts (for a 60-day or two-year period) and "qualified subchapter S trusts" may not be shareholders in a S corporation. A "qualified subchapter S trust" is a trust which is required to have only one current income beneficiary (for life). All the income (as defined for local law purposes) must be currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation.

Description of Proposal

In general

The proposal would allow stock in an S corporation to be held by certain trusts. In order to qualify for this treatment, all beneficiaries of the trust must be individuals (or estates). No interest in the trust could be acquired by purchase. Each potential current beneficiary of the trust would be counted as a shareholder for purposes of the 35-shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder).

Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations would be treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust would be taxed at the highest individual rate (currently 31 percent) on this portion of the trust's income. The taxable income attributable to this portion would include the income allocated to it under the rules of subchapter S, gain or loss from the sale of the S corporation stock, and to the extent provided in regulations, any state and income taxes and administrative expenses of the trust properly allocable to the S corporation stock.

No deduction would be allowed for amounts distributed to beneficiaries in computing this tax, and no deduction would be allowed for any item other than the subchapter S items described above. This income would not be included in the distributable net income of the trust, and thus would not be included in the beneficiaries' income.

Treatment of remainder of items held by trust

The items taken into account by the subchapter S portion of the trust would be disregarded in computing the income tax of the remaining portion of the trust. Distributions from the trust would be deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J. However, the trust's distributable net income would not include any income attributable to the S corporation stock. The trust would make an election to be taxed under this system. The election could be revoked only with the consent of the Secretary of the Treasury.

Effective Date

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

D. Minimum Tax Provision

1. Treatment of built-in losses for purposes of the corporate alternative minimum tax

Present Law

For purposes of the regular corporate tax, if at the time of an ownership change, a corporation has a net operating loss or a net unrealized built-in loss, the use of such losses in post-change periods is limited. A corporation has a net unrealized built-in loss if the aggregate adjusted bases of the assets of the corporation exceed the fair market value of the assets immediately before the change of ownership (sec. 382).

For purposes of the adjusted current earnings (ACE) component of the corporate alternative minimum tax (AMT), if a corporation with a net unrealized built-in loss undergoes an ownership change in a taxable year beginning after 1989, the adjusted basis of each asset of such corporation generally is adjusted to each asset's fair market value (sec. 56(g)(4)(G)). This rule essentially eliminates, rather than limits, the use of built-in losses for ACE purposes. The net operating loss of a corporation, on the other hand, is not eliminated for AMT purposes after a change of ownership.

Description of Proposal

The proposal would repeal the ACE rule relating to the treatment of built-in losses after a change of ownership. Thus, for ACE purposes, the treatment of built-in losses would be similar to the treatment of net operating loss carryovers (in the same way that the treatment of built-in losses is similar to the treatment of net operating losses for regular tax purposes).

Effective Date

The proposal would be effective for changes of ownership occurring after December 31, 1991.

E. Partnership Provisions

General Partnership Provisions

1. Simplified flow-through for large partnerships

Present Law

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

Description of Proposal

The proposal modifies the tax treatment of a large partnership (generally, a partnership with at least 250 partners, or an electing partnership with at least 100 partners) and its partners. The bill provides that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; and (10) creditable foreign taxes and foreign source items.

All limitations and other provisions affecting the computation of taxable income or any credit generally are applied at the partnership (and not the partner) level. In addition, all elections affecting the computation of taxable income or any credit generally are made by the partnership.

The simplified reporting regime does not apply to service or commodity partnerships. In addition, special rules apply to large partnerships holding oil and gas properties.

For all partners contributing property to a large partnership, the bill replaces section 704(c) with a "deferred sale" approach. Under the bill, a large partnership takes a fair market value basis in the property, and the contributing partner's precontribution gain or loss

is deferred until the occurrence of specified recognition events.

Effective Date

The proposal generally applies to partnership taxable years ending on or after December 31, 1993.

2. Simplified audit procedures for large partnerships

Present Law

In general

Prior to 1982, regardless of the size of a partnership, adjustments to a partnership's items of income, gain, loss, deduction, or credit had to be made in separate proceedings with respect to each partner individually. Because a large partnership sometimes had many partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the partnership had to be made in numerous actions in several jurisdictions, sometimes with conflicting outcomes.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Administrative proceedings

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. But the IRS must still assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

Any partner of a partnership can request an administrative adjustment or a refund for his own separate tax liability. Any partner also has the right to participate in partnership-level administrative proceedings. A settlement agreement with respect to partnership items binds all parties to the settlement.

Tax Matters Partner

The TEFRA rules establish the "Tax Matters Partner" as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner

designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice requirements

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Adjudication of disputes concerning partnership items

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Statute of limitations

The IRS generally cannot adjust a partnership item for a partnership taxable year if more than 3 years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return.

Description of Proposal

The proposal would create a new audit system for large partnerships. The proposal defines "large partnership" the same way for audit and reporting purposes (generally, partnerships with at least 250 partners) except that certain oil and gas partnerships are large partnerships for the audit rules but are not subject to the large partnership reporting requirements.

As under present law, large partnerships and their partners are subject to unified audit rules. Unlike present law, however, partnership adjustments generally will flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners will adjust their current-year share of partnership items of income, gains, losses, deductions, or credits to reflect partnership adjustments that take effect that year. The adjustments generally will not affect prior year returns of any partners (except in the case of changes to any partner's distributive shares).

Effective Date

The proposal would be effective for partnership taxable years ending on or after December 31, 1993.

3. **Advance due date for furnishing information to partners of large partnerships**

Present Law

A partnership required to file an income tax return with the IRS must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a partnership must file its income tax return on or before the fifteenth day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships). This is the same deadline by which most individual partners must file their tax returns.

Description of Proposal

The proposal provides that a large partnership must furnish information returns to partners by the first March 15 following the close of the partnership's taxable year. Large partnerships would be only those partnerships subject to the simplified reporting rules for large partnerships.

Effective Date

The proposal is effective for taxable years ending on or after December 31, 1993.

4. **Partnership returns on magnetic media**

Present Law

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Description of Proposal

The proposal authorizes the IRS to require large partnerships, and other partnerships with 250 or more partners, to provide the tax return of the partnership and copies of the schedules sent to each partner, to the IRS on magnetic media.

Effective Date

For partnerships that are large partnerships (as defined in the simplified reporting provision), the provision applies to partnership taxable years ending on or after December 31, 1993. For partnerships that are not large partnerships (as defined) but that have 250 or more partners, the provision applies to partnership taxable years ending on or after

December 31, 1998.

5. Close partnership taxable year with respect to deceased partner

Present Law

The taxable year of a partnership closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Such year, however, generally does not close upon the death of a partner. Thus, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return. (See *Estate of Hesse v. Commissioner*, 74 T.C. 1307, 1311 (1980).

Description of Proposal

The proposal provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise.

The proposal is not intended to change present law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 78 or 11 of Title 11, relating to bankruptcy).

Effective Date

The proposal applies to partnership taxable years beginning after December 31, 1992.

Partnership Proceedings Under TEFRA[1]

1. Clarify the treatment of partnership items in deficiency proceedings

Present Law

TEFRA partnership proceedings must be kept separate from deficiency proceedings involving the partners in their individual capacities. Prior to the Tax Court's opinion in Munro v. Commissioner, 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding, and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

Faced with this situation in Munro, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Description of Proposal

The proposal is intended to overrule Munro and allow the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This will eliminate the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and will restore to taxpayers a prepayment forum with respect to the TEFRA items. In addition, the proposal provides a special rule to address the factual situation presented in Munro.

Effective Date

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[1] Tax Equity and Fiscal Responsibility Act of 1982.

The proposal is effective for partnership taxable years ending after the date of enactment.

2. Permit the IRS to rely on partnership returns to determine the proper audit procedures

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Description of Proposal

The proposal permits the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the proposal permits the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Effective Date

The proposal is effective for partnership taxable years ending after the date of enactment.

3. Statute of limitations

a. Suspend statute when an untimely petition is filed

Present Law

In a deficiency case, section 6503(a) provides that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection is suspended until the decision of the Tax Court becomes final, and for 60 days thereafter. The counterpart to this provision with respect to TEFRA cases is contained in section 6229(d). That section provides that the period of limitations is suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely.

Description of Proposal

The proposal is designed to conform the suspension rule for the filing of petitions in TEFRA cases with the rule under section 6503(a) pertaining to deficiency cases. Under the proposal, the statute of limitations in TEFRA cases would be suspended by the filing of any petition under section 6226, regardless of whether the petition is timely or valid, and the suspension will remain in effect until the decision of the court becomes final, and for one year thereafter. Hence, if the statute of limitations is open at the time that an untimely petition is filed, the limitations period will no longer continue to run and possibly expire while the action is pending before the court.

Effective Date

The proposal is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

b. Suspend statute of limitations during bankruptcy proceedings

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502.

Under present law, because the suspension provision in section 6503(h) applies only to the limitations periods provided in section 6501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result, the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay provisions of the Bankruptcy Code.

Description of Proposal

The proposal clarifies that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period is for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment, and for 60 days thereafter. The proposal is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The proposal is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

c. **Extend statute of limitations for bankrupt TMPs**

Present Law

Section 6229(b)(1)(B) provides that the statute of limitations is extended with respect to all partners in the partnership by an agreement entered into between the tax matters partner (TMP) and the IRS. However, Temp. Treas. Reg. secs. 301.6231(a)(7)-1T(l)(4) and 301.6231(c)-7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items convert to nonpartnership items, and if the debtor was the tax matters partner, such status terminates. These rules are necessary because of the automatic stay provision contained in 11 U.S.C. sec. 362(a)(8). As a result, if a consent to extend the statute of limitations is signed by a person who would be the TMP but for the fact that at the time that the agreement is executed the person was a debtor in a bankruptcy proceeding, the consent would not be binding on the other partners because the person signing the agreement was no longer the TMP at the time that the agreement was executed.

Description of Proposal

The proposal provides that unless the IRS is notified of a bankruptcy proceeding in accordance with regulations, the IRS can rely on a statute extension signed by a person who would be the tax matters partner but for the fact that said person was in bankruptcy at the time that the person signed the agreement. Statute extensions granted by a bankrupt TMP in these cases will be binding on all of the partners in the partnership. The proposal is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The proposal is effective for extension agreements entered into after the date of enactment.

4. **Expand small partnership exception from TEFRA**

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Description of Proposal

The proposal permits a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the proposal retains the prohibition of present law against having a flow-through entity (other than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Effective Date

The proposal is effective for partnership taxable years ending after the date of enactment.

5. **Exclude partial settlements from 1-year assessment rule**

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

Description of Proposal

The proposal provides that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items would be determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the

partnership taxable year shall be controlling with respect to all disputed partnership items for the partnership taxable year. The proposal is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The proposal is effective for settlements entered into after the date of enactment.

6. Extend time for filing a request for administrative adjustment

Present Law

If an agreement extending the statute is entered into with respect to a non-TEFRA statute of limitations, that agreement also extends the statute of limitations for filing refund claims (sec. 6511(c)). There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Description of Proposal

The proposal provides that if a TEFRA statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims attributable to partnership items or affected items until 6 months after the expiration of the limitations period for assessments.

Effective Date

The proposal is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

7. Provide innocent spouse relief for TEFRA proceedings

Present Law

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (sec. 6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Description of Proposal

The proposal provides both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

With respect to a prepayment forum, the proposal provides that within 60 days of the date that a notice of computational adjustment relating to partnership items is mailed to the spouse of a partner, the spouse may request that the assessment be abated. Upon receipt of such a request, the assessment will be abated and any reassessment will be subject to the deficiency procedures. If an abatement is requested, the statute of limitations will not expire before the date which is 60 days after the date of the abatement. If the spouse files a petition with the Tax Court, the Tax Court will only have jurisdiction to determine whether the requirements of section 6013(e) have been satisfied. In making this determination, the treatment of the partnership items that gave rise to the liability in question will be conclusive.

Alternatively, the proposal provides that the spouse of a partner may file a claim for refund to raise the innocent spouse defense. The claim must be filed within 6 months from the date that the notice and demand (or notice of computational adjustment) is mailed to the spouse. If the claim is not allowed the spouse may file a refund action. For purposes of any claim or suit under this proposal, the treatment of the partnership items that gave rise to the liability in question will be conclusive.

Effective Date

The proposal is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

8. Determine penalties at the partnership level

Present Law

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Description of Proposal

The proposal provides that the partnership level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the proposal allows partners to raise any partner-level defenses in a refund forum.

Effective Date

The proposal is effective for partnership taxable years ending after the date of enactment.

9. Clarify jurisdiction of the Tax Court

Present Law

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding, "may be enjoined in the proper court." Present law may be unclear as to whether this includes the Tax Court.

For a partner other than the Tax Matters Partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to them.

Description of Proposal

The proposal clarifies that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The proposal also permits a partner to participate in an action or file a petition for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person. Additionally, the proposal clarifies that the Tax Court has overpayment jurisdiction with respect to affected items.

Effective Date

The proposal is effective for partnership taxable years ending after the date of enactment.

10. Treatment of premature petitions filed by certain partners

Present Law

The Tax Matters Partner is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the Tax Matters Partner does not file a petition within the 90-day period, certain other partners are permitted to file a

petition within the 60-day period after the close of the 90-day period. There are ordering rules for determining which action goes forward and for dismissing other actions.

Description of Proposal

The proposal treats premature petitions filed by certain partners within the 90-day period will be treated as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that is not available under present law.

Effective Date

The proposal is effective with respect to petitions filed after the date of enactment.

11. Clarify bond requirement for appeals from TEFRA proceedings

Present Law

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

Description of Proposal

The proposal clarifies that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership). For purposes of this proposal, the amount of the bond may be estimated by applying the highest individual rate to the total adjustments determined by the Tax Court and doubling that amount to take into account interest and penalties.

Effective Date

The proposal is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

12. Suspend interest where there is a delay in computational adjustment resulting from TEFRA settlements

Present Law

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections, and

the IRS does not issue a notice and demand for payment of such deficiency within 30 days. Interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings, however, is not suspended.

Description of Proposal

The proposal suspends interest where there is a delay in making a computational adjustment relating to a TEFRA settlement.

Effective Date

The proposal is effective with respect to settlements entered into after the date of enactment.

F. Cooperative Provisions

1. Discharge of indebtedness income from prepayment of REA loans

Present Law

Under section 501(c)(12) of the Code, a rural electric cooperative is generally exempt from Federal income tax if at least 85 percent of the cooperative's income is derived from its members. Accordingly, cancellation of indebtedness income generally must be taken into account in determining the percentage of a cooperative's income derived from members. In two prior technical corrections, Congress has provided that the 85-percent test is determined without regard to any cancellation of indebtedness income arising from the prepayment of a loan pursuant to certain sections of the Rural Electrification Act ("REA Act"), as in effect on January 1, 1987.

Section 2387 of the Food, Agriculture, Conservation, and Trade Act of 1990 (the "1990 Farm Act") amended section 306B of the REA Act to provide that rural electric cooperatives that merge with another rural electric cooperative that previously prepaid REA loans under the 1988 or 1989 Budget Reconciliation Acts also could prepay REA loans at a discount. Because this amendment occurred after January 1, 1987, the cancellation of indebtedness income arising from such prepayments would not be excluded in determining the 85-percent test under present law.

Description of Proposal

The proposal provides that the 85-percent test of section 501(c)(12) would be determined without regard to cancellation of indebtedness income arising from the prepayment of REA loans as permitted under the amendments made by the 1990 Farm Act.

Effective Date

The proposal would be effective with respect only to prepayments of REA loans made after December 31, 1992.

2. Treatment of amounts received by telephone cooperatives

Present Law

Mutual or cooperative telephone companies ("telephone cooperatives") are exempt from Federal income tax if 85 percent of more of their income consists of amounts collected from members for the sole purpose of meeting losses and expenses. In applying this 85-percent test, certain income received by a telephone cooperative is disregarded, including income received from a nonmember telephone company for the performance of communication services which involve members of the telephone cooperative (sec. 501(c)(12)(B)).

Description of Proposal

For purposes of the 85-percent test under section 501(c)(12), 50 percent of the income received by a telephone cooperative from a nonmember telephone company for performing communication services--e.g., fees received for originating (or terminating) a long-distance call placed by (or to) a member--would be treated as collected from members of the telephone cooperative. The remaining 50 percent of income received by a telephone cooperative from a nonmember telephone company would, as under present law, be excluded from the 85-percent test under section 501(c)(12)(B)(i).

The proposal also excludes from the 85-percent test under section 501(c)(12) amounts received by a telephone cooperative from billing and collection services performed for another telephone company.

In addition, under the proposal, telephone cooperatives would not lose their tax-exempt status if they earn certain investment "reserve income" in excess of 15 percent of their total income, but only if such reserve income does not exceed 35 percent of the cooperative's total income. Tax-exempt telephone cooperatives would be subject to the unrelated business income tax (UBIT) on their reserve income between the 15-percent and 35-percent range.

Effective Date

The proposal would be effective for amounts received or accrued after December 31, 1992.

3. Treatment of certain housing cooperatives

Present Law

Under section 277, costs incurred by a "membership organization" attributable to furnishing services, insurance, goods or other items of value to its members are deductible in any taxable year only to the extent of any income the organization has derived from its members. The Internal Revenue Service has held that section 277 applies to housing cooperatives,[1], while certain courts have held that section 277 does not apply to housing cooperatives subject to tax under subchapter T.[2]

Description of Proposal

The proposal would clarify that section 277 does not apply to a "cooperative housing corporation" (as described in section 216(b)(1). The proposal would, however, adopt a rule similar to section 277 that patronage losses of the corporation cannot offset earnings that are not patronage earnings.

For this purpose, the proposal defines patronage earnings and losses to mean "earnings and losses ... derived from business done with or for patrons of the corporation." Moreover, the proposal specifically treats the following items as "patronage earnings": (1) interest on reasonable reserves established in connection with the corporation, including reserves required by a government agency or lender, (2) rents from laundry and parking to the extent attributable to use of the facilities by tenant-stockholders (as defined in Section 216(b)(2)) and their guests, and (3) in the case of certain "limited equity cooperative housing corporations", rental income attributable to housing projects operated by such corporations.

No inference shall be drawn from the proposal regarding the deductibility of patronage losses under present law.

Effective Date

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

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[1] See Rev. Rul. 90-36, 1990-1 C.B. 59.
[2] See Landmark v. United States, 92-1 Tax Cas. (CCH) para. 50,058 (Ct. Cl. 1992); Farm Services Cooperative v. Commissioner, 70 T.C. 145, 155-57, (1978), rev'd on other grounds, 611 F.2d 1270 (9th Cir. 1980).

4. Treatment of safe-harbor leases of membership organizations

Present Law

Present law provides that, in the case of a membership organization (such a cooperative), losses from transactions with members cannot be used to offset income from transactions with nonmembers. The Internal Revenue Service has taken the position that the interest income derived from a safe-harbor sale-leaseback transaction is income not derived from transactions with members while the rental expense from such a sale-leaseback transaction must be allocated between income derived from members and nonmembers.

Description of Proposal

Under the proposal, the interest income and rental expense from the sale and leaseback of the property under a safe-harbor lease would be netted and any difference would be allocated between members and nonmembers in proportion to the business done with each group.

Effective Date

The proposal would be effective for all taxable years beginning before, on, or after the date of enactment.

Subpart C. Compliance Provisions

A. Administrative Provisions

1. Simplify employment tax reporting for household employees

Present Law

An employer who pays a household employee wages of $50 or more in a calendar quarter for household work must withhold social security taxes (including medicare taxes) from wages paid to the employee during the quarter. The employer must also pay an amount of tax that matches the tax withheld from the employee's wages. The employer must file an Employer's Quarterly Tax Return (Form 942) each quarter and a Wage and Tax Statement (Form W-2) at the end of the year.

In addition, an employer must pay federal unemployment taxes if he or she paid cash wages to household employees totalling $1,000 or more in a calendar quarter in the current or preceding year. The employer must file an Employer's Annual Federal Unemployment Tax Return (Form 940 or Form 940-EZ) at the end of the year.

Description of Proposal

The proposal would change the threshold for withholding and paying social security taxes from $50 a quarter to $300 a year. The proposal would require an individual who employs only household employees to report any social security or federal unemployment tax obligation for wages paid to such employees on his or her income tax return for the year. The proposal would include a household employer's social security and unemployment taxes in the estimated tax provisions. The proposal would authorize the Secretary to enter into agreements with States to collect state unemployment taxes in the same manner.

The proposal would authorize the Treasury to issue regulations to implement this provision.

Effective Date

The proposal would be effective for remuneration paid in calendar years beginning after December 31, 1991.

2. Penalties for failure to provide reports relating to pension payments

Present Law

Any person who fails to file an information report with

the Internal Revenue Service on or before the prescribed filing date is subject to penalties for each failure. The general penalty structure provides that the amount of the penalty is to vary with the length of time within which the taxpayer corrects the failure, and allows taxpayers to correct a de minimis number of errors and avoid penalties entirely (sec. 6721). A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments (sec. 6652(e)).

Description of Proposal

The proposal would incorporate into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients. Thus, information reports with respect to pension payments would be treated in a similar fashion to other information reports.

Effective Date

The proposal would apply to returns and statements the due date for which is after December 31, 1991.

3. Clarify that reproductions from digital images are reproductions for recordkeeping purposes

Present Law

Reproductions of a return, document, and certain other matters have the same legal status as the original for purposes of judicial and administrative proceedings. It is unclear whether reproductions made from digital images are also accorded the same legal status as originals.

Description of Proposal

The proposal would provide that the term reproduction includes a reproduction from a digital image. The proposal would also require the Comptroller General to conduct a study of available digital image technology for the purpose of determining the extent to which reproductions of documents stored using that technology accurately reflect the data on the original document and the appropriate period for retaining the original document.

Effective Date

The proposal would be effective on the date of enactment.

4. Repeal of authority to disclose whether a prospective juror has been audited

Present Law

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary must disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service (sec. 6103(h)(5)).

Description of Proposal

The proposal would repeal the requirement that the Secretary disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.

Effective Date

The proposal would be effective for judicial proceedings pending on, or commenced after, the date of enactment.

5. Repeal TEFRA audit rules for S corporations

Present Law

An S corporation generally is not subject to income tax on its taxable income. Instead, it files an information return and the shareholders report their pro rata share of the S corporation's income and deductions on the shareholders' tax return.

The Subchapter S Revision Act of 1982 generally made the TEFRA partnership audit and litigation rules applicable to S corporations. These rules require the determination of all "Subchapter S items" at the corporate, rather than the shareholder, level. These rules also require a shareholder to report all Subchapter S items consistently with the corporation's information return or to notify the IRS of any inconsistency. Temporary regulations contain an exception from these rules for "small S corporations," i.e., those with five or fewer shareholders, each of whom is a natural person or an estate.

Description of Proposal

The proposal would repeal the unified audit procedures for S corporations. The proposal would retain, however, the requirement that shareholders report items in a manner

consistent with the corporation's return.

Effective Date

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

6. Clarify statute of limitations for items from passthrough entities

Present Law

Passthrough entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due.

Some believe that present law may be unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or individual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). (Compare Fehlhaber v. Comm., 94 TC 863 (1990) with Kelly v. Comm., 877 F.2d 7567 (9th Cir. 1989)).

Description of Proposal

The proposal would clarify that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit. The proposal is not intended to create any inference as to the proper interpretation of present law.

Effective Date

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

B. Tax Court Provisions

1. Clarify jurisdiction of Tax Court with respect to overpayment determinations

Present Law

The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Court's decision becomes final. Whether such an order is appealable is uncertain.

In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Description of Proposal

The proposal would clarify that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The proposal would also clarify that the Tax Court does not have jurisdiction over the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Effective Date

The proposal would be effective on the date of enactment.

2. Clarify procedures for administrative cost awards

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

No time limit is specified for the taxpayer to apply to the IRS for an award of administrative costs. In addition, no time limit is specified for a taxpayer to appeal to the Tax Court an IRS decision denying an award of administrative costs. Finally, the procedural rules for adjudicating a denial of administrative costs are unclear.

Description of Proposal

The proposal would provide that a taxpayer who seeks an award of administrative costs must apply for such costs within 90 days of the date on which the taxpayer was determined to be a prevailing party. The proposal would provide that a taxpayer who seeks to appeal an IRS denial of an administrative cost award must petition the Tax Court within 90 days after the date that the IRS mails the denial notice.

The proposal would clarify that dispositions by the Tax Court of petitions relating only to administrative costs are to be reviewed in the same manner as other decisions of the Tax Court.

Effective Date

The proposal would be effective on the date of enactment.

3. Clarify Tax Court jurisdiction over interest determinations

Present Law

A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court.

The proposal would provide that a taxpayer must file a "motion" (rather than a "petition") to seek a redetermination of interest in the Tax Court.

Effective Date

The proposal would be effective on the date of enactment.

4. Clarify net worth requirements for awards of administrative or litigation costs

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

A person who substantially prevails must meet certain net worth requirements to be eligible for an award of

administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

Description of Proposal

The proposal would provide that the net worth limitations currently applicable to individuals also apply to estates and trusts. The proposal would also provide that individuals who file a joint tax return shall be treated as one individual for purposes of computing the net worth limitations. Consequently, the net worth of both spouses would be aggregated for purposes of this computation. An exception to this rule would be provided in the case of a spouse otherwise qualifying for innocent spouse relief.

Effective Date

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

C. Permit IRS to Enter Into Cooperative Agreements With State Tax Authorities

Present Law

The IRS is generally not authorized to provide services to non-Federal agencies even if the cost is reimbursed (62 Comp. Gen. 323,335 (1983)).

Description of Proposal

The proposal would provide that the Secretary is authorized to enter into cooperative agreements with State tax authorities to enhance joint tax administration. These agreements may include (1) joint filing of Federal and State income tax returns, (2) single processing of these returns, and (3) joint collection of taxes (other than Federal income taxes).

The proposal would provide that these agreements may require reimbursement for services provided by either party to the agreement. Any funds appropriated for tax administration may be used to carry out the responsibilities of the IRS under these agreements, and any reimbursement received under an agreement shall be credited to the amount appropriated.

No agreement may be entered into that does not provide for the protection of confidentiality of taxpayer information that is required by section 6103.

Effective Date

This proposal would be effective on the date of enactment.

D. Employment Tax Provision

1. Employment tax status of certain fishermen

Present Law

Under present law, service as a crew member on a fishing vessel is generally excluded from the definition of employment for purposes of income tax withholding on wages and for purposes of FICA and FUTA taxes if the operating crew of the boat normally consists of fewer than 10 individuals, the individual receives a share of the catch based on the total catch, and the individual does not receive cash remuneration other than proceeds from the sale of the individual's share of the catch. Reporting is required with respect to amounts paid to crew members covered by the exemption.

Description of Proposal

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

Effective Date

The proposal would apply to remuneration paid on or after January 1, 1992. In addition, the proposal would apply to remuneration paid after December 31, 1984, and before January 1, 1993, unless the payor treated such remuneration when paid as being subject to wage withholding and employment taxes.

Subpart D. Foreign Tax Provisions

1. Deferral of tax on income earned through foreign corporations and exceptions to deferral

Present Law

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") generally are taxed currently by the United States on their worldwide income. Income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment to its U.S. stockholders.

The Code sets forth several regimes providing exceptions to the general rule deferring U.S. tax on income earned indirectly through a foreign corporation: the controlled foreign corporation rules (secs. 951-964); the foreign personal holding company rules (secs. 551-558); passive foreign investment company (PFIC) rules (secs. 1291-1297); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and rules for foreign investment companies (sec. 1246) and electing foreign investment companies (sec. 1247). These separate regimes have complex and overlapping application to foreign corporations with U.S. stockholders.

Description of Proposal

In general

The proposal replaces the separate anti-deferral regimes of present law with a unified set of rules providing for either partial or full elimination of deferral depending on the circumstances. The proposal preserves the present-law approach under which partial current taxation is a function of the type of income earned by the foreign corporation and a level of U.S. ownership in the corporation exceeding some threshold (as currently embodied in subpart F). The proposal also preserves the present-law approach under which full current taxation is a function of a type of income or assets of the corporation exceeding some threshold (as currently embodied in subpart F, the PFIC rules, and the foreign personal holding company rules). The proposal eliminates regimes that are redundant or marginally applicable, and ensures that no more than one set of rules generally will apply to a shareholder's interest in any one corporation in any one year.

Generally, the proposal retains the subpart F rules as the foundation of its unified anti-deferral regime (with certain modifications described below and also in item 2.,

following). It includes a modified version of the PFIC rules while eliminating the other regimes as redundant to one or the other. The proposal's unified anti-deferral regime sets forth various thresholds for subjecting U.S. persons to full or partial inclusions of corporate income. In addition, where deferral is eliminated by U.S. shareholder inclusions of foreign corporate-level income, the proposal applies a single set of rules (the subpart F rules) for basis adjustments, characterization of actual distributions, foreign tax credits, and similar issues. As under present law, the proposal in some cases affords U.S. persons owning stock in foreign corporations a choice of technique for recognizing income from the elimination of deferral. However, in a greater number of cases than under present law, the proposal provides only one method of eliminating deferral.

Replacement of current law regimes for full elimination of deferral

The proposal creates a single definition of a passive foreign corporation (PFC) that will unify and replace the foreign personal holding company and PFIC definitions. The rules applicable to PFCs represent a hybrid of characteristics of the foreign personal holding company rules, the PFIC rules, and the controlled foreign corporation rules (subpart F), plus a new mark-to-market regime, as well as a variety of simplifying or technical changes to rules under the existing systems. The following discussion explains the differences between the PFIC provisions of present law and the PFC provisions applicable under the proposal.

A PFC is any foreign corporation if (1) 60 percent or more of its gross income is passive income, (2) 50 percent or more of its assets (on average during the year, measured by value) produce passive income or are held for the production of passive income, or (3) it is registered under the Investment Company Act of 1940 (as amended) either as a management company or as a unit investment trust.[1] As under the PFIC rules, the foreign corporation is permitted to elect to measure its assets based on their adjusted bases rather than their value.

As under present law, passive income for this purpose is defined in the proposal generally as any income of a kind which would be foreign personal holding company income as defined in section 954(c), subject to the current law

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[1] It is understood that a mutual insurance company can be treated under the proposal and under present law as a passive foreign corporation, notwithstanding the fact that such a company does not actually issue "stock."

exceptions for banking and insurance income and the current look-through rules for certain payments from related persons (current sec. 1296(b)(2)).[2]

The proposal adds a new exception to the definition of passive income. Under the proposal, to the extent that any asset is properly treated as not held for the production of passive income (and therefore is treated as not a passive asset for purposes of the asset test), all income derived from the asset is treated as active income for purposes of the income test. Ordinarily the character of an asset as passive or active depends on the income generated by that asset. However, as explained above, some assets (for example, stocks or securities held for sale to customers in the ordinary course of business by a regular dealer in such property, and properly identified as inventory property) may be treated as active even though those assets generate, among other things, passive income. It is unclear whether this was intended when the PFIC rules were enacted.[3]

The proposal establishes that, to the extent an asset is properly treated as active, all of the income from that asset is treated as active for purposes of the income test. The proposal is not intended to change the outcome of the application of the asset test under present law. For example, it would not be intended to limit the IRS's authority to prescribe limits, as it did in Notice 88-22, on the cases in which assets generating what could be passive income are treated as active assets.[4] In addition, it would

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[2] Thus, the proposal retains the exception for income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation. It would be intended that in determining whether a corporation is "predominantly engaged" for this purpose, the Secretary may require a higher standard or threshold than the definition of an insurance company under Treasury Regulations section 1.801-3(a).

[3] Active asset treatment of certain securities held for sale to the public is confirmed in Notice 88-22, 1988-1 C.B. 489, 490, and S. Rep. No. 100-445, 100th Cong., 2d Sess. 281 (1988). The legislative history of the 1986 Act further suggested a view that all income from such inventory would be treated as active. "[S]ecurities held for sale to the public[] are assets that do not give rise to subpart F FPHC income by virtue of the dealer exception in sec. 954(c)...." Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., _General Explanation of the Tax Reform Act of 1986,_ at 1025 (1987).

(Footnote continued)

be intended that where one item of property is properly viewed as two separate assets, a portion of the property can be treated as a passive asset that generates passive income while another portion of the same property can be treated as a nonpassive asset that generates nonpassive income. For example, assume that a taxpayer owns a six-story office building, and occupies two floors for use in its active business while renting out the other four floors. Assume that the two floors used in the active business are properly viewed as a nonpassive asset, while the four leased floors are properly viewed as a passive asset. It would be intended that the rental income from the four leased floors in this example be treated as passive income.

It is understood that dealers in stocks and securities engage in securities sale and repurchase transactions (so-called "repos" and "reverses") and securities lending and borrowing transactions. For example, it is understood that securities dealers may engage in offsetting repo and reverse transactions--i.e., may run a "matched book" with respect to such transactions. In addition, it is understood that securities dealers enter into reverse repos and securities borrowing transactions to cover short sales and failed deliveries of securities for settlement of trades, and use repos and securities loans to finance inventory positions.

It is understood that such transactions engaged in by regular dealers in stocks or securities may generate some income that is treated as passive under the PFIC rules of present law. It would be intended that a study be conducted by the Treasury Department as to the tax treatment for purposes of the PFC rules of such transactions, and the consequences and merits of possible changes in such current-law tax treatment. It would be intended that the Treasury study be completed within one year after the date of enactment of the proposal.

In addition, the proposal provides a clarification to present law. The proposal clarifies that, as indicated in the legislative history of the 1988 Act, the same-country exceptions from the definition of foreign personal holding company income in section 954(c) do not apply in determining passive income for purposes of the PFIC definition.[5]

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[4](continued)
[4] Under the Notice, for example, the IRS conditioned active asset treatment of securities inventories on compliance with an identification requirement and a reasonable needs requirement. 1988-1 C.B. at 490.

[5] H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 272 (1988); S. Rep. No. 100-445, 100th Cong., 2d Sess. 285 (1988).

The proposal modifies the present law application of the asset test by treating certain leased property as assets held by the foreign corporation for purposes of the PFC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months. Under the proposal, the value of leased property for purposes of applying the asset test is the lesser of the fair market value of the property or the unamortized portion of the present value of the payments under the lease. Regulations are to provide for determining the unamortized portion of the present value of the payments. Present value is to be determined, under regulations, as of the beginning of the lease term, and, except as provided in regulations, by using a discount rate equal to the applicable Federal rate determined under the rules applicable to original discount instruments (sec. 1274(d)), substituting under those rules the term of the lease for the term of the debt instrument. In applying those rules, options to renew or extend the lease are not to be taken into account. Also, the special rule to be applied under section 1274(d)(2) in the case of a sale or exchange is disregarded. Property leased by a corporation is not taken into account in testing for PFC status under the asset test either if the lessor is a related person (as that term is defined under the foreign base company rules) with respect to the lessee, or if a principal purpose of leasing the property was to avoid the PFC provisions.

The proposal also modifies the present law rules that provide an exception from the definition of a PFIC in the case of a company changing businesses. Under the proposal, if a foreign corporation holds 25 percent or more of the stock of a second corporation that qualifies for the change-of-business exception (current sec. 1297(b)(3)), then in applying the look-though rules (current sec. 1296(c)), the first corporation may treat otherwise passive assets or income of the second corporation as active.[6]

The proposal generally retains those provisions of current law the application of which depends upon whether a foreign corporation was a PFIC for years after 1986 (e.g., current sec. 1291(d)), but modifies these provisions to test whether the foreign corporation was a PFC for years after 1986. As a transitional definition, the proposal provides

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6 The proposal retains the present law rules that provide an exception from the definition of a PFIC in the case of a start-up company (current sec. 1297(b)(2)). Under the proposal, it would be intended that the start-up company exception be applied, where necessary to carry out the purposes of the PFC rules, by treating as one corporation all related foreign corporations that transferred assets to the start-up company.

that a foreign corporation that was treated as a PFIC for any taxable year beginning before the introduction of the proposal is treated as having been a PFC for each such year.

The proposal provides a new election that will allow certain passive foreign corporations to be treated as domestic corporations. A foreign corporation is eligible to make this election if (1) it would qualify for treatment as a regulated investment company (RIC) under the relevant provisions of the Code if it actually were a domestic corporation, (2) it meets such requirements as the Secretary may prescribe to ensure the collection of taxes imposed by the Internal Revenue Code on the passive foreign corporation, and (3) the electing passive foreign corporation waives all benefits which are granted by the United States under any treaty (including treaties other than tax treaties) and to which the corporation is otherwise entitled by reason of being a resident of another country. The rules governing such an election generally will be similar to those applicable to the election by a foreign insurance company to be treated as a domestic corporation under section 953(d). The rules governing the election under the PFC rules, however, will not include rules similar to the special rules applicable under section 953(d) for pre-effective-date earnings and profits (sec. 953(d)(4)(B)).

The proposal provides a special rule regarding the application of the PFC rules to tax-exempt organizations that own stock in passive foreign corporations. The PFC rules, under the proposal, apply to any stock held by a tax-exempt organization (under section 501) in a passive foreign corporation only to the extent that a dividend on that stock would be taken into account in determining the organization's unrelated business taxable income. To that extent, the PFC rules apply with respect to amounts taken into account in computing unrelated business taxable income in the same manner as if the organization were fully taxable. Even if a dividend on the PFC stock would not be taken into account in determining the organization's unrelated business taxable income, however, it would be intended that any U.S. corporation regardless of its tax-exempt status will be treated as a U.S. person for purposes of determining whether or not a PFC is U.S. controlled.

Tax treatment under full elimination of deferral

The benefits of deferral are eliminated with respect to the income of a PFC under three alternative methods: current inclusion, mark-to-market, or interest charge on excess distributions.

Current inclusion method

Mandatory current inclusion.--If a passive foreign corporation is U.S. controlled, the proposal will subject every U.S. person owning (directly or indirectly) stock in the PFC to income inclusions under a modified version of the controlled foreign corporation rules. If a PFC is not U.S. controlled, every U.S. person owning (directly or indirectly) 25 percent or more of the vote or value of the stock of the PFC will be subject to the same rules. Under the proposal, the entire gross income of the passive foreign corporation (subject to applicable deductions) is treated as foreign base company income, and thus is included (net of appropriate deductions) on a pro rata basis in the income of each U.S. person directly or indirectly owning stock in the PFC, under a modified application of the rules of sections 951 and 961.[7] Actual distributions of earnings by such a PFC are treated similarly to distributions of previously taxed income under sections 959 and 961. These rules supersede all application of the present-law rules applicable to foreign personal holding companies, under which earnings are deemed distributed and then contributed to the capital of the foreign personal holding company.

In applying the subpart F inclusion rules to PFC inclusions, the proposal applies the subpart F high-tax exception (under sec. 954(b)(4)) only to those shareholders in the PFC who are treated as "U.S. shareholders" of a controlled foreign corporation under the general rules of subpart F (i.e., those who own, whether directly, indirectly, or constructively, at least 10 percent of the voting power of the controlled foreign corporation). This limitation on the application of the controlled foreign corporation rules preserves present law to the extent that no high-tax exception is available to PFICs that are not also controlled foreign corporations. However, because the proposal repeals the foreign personal holding company provisions of the Code, the effect of this high-tax exception is to increase the possibility for deferral in the case of a company that under present law meets the definitions of both a controlled foreign corporation and a foreign personal holding company.

Also in general conformity with present law, the proposal permits the character of the PFC's income as either ordinary income or capital gain to be passed through to those shareholders of the PFC who are not treated as "U.S. shareholders" of a controlled foreign corporation under the general rules of subpart F (i.e., those who do not own,

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[7] The treatment of PFC income as foreign base company income for purposes of subpart F is not intended to affect the application of look-through treatment of that income for purposes of the foreign tax credit limitation.

whether directly, indirectly, or constructively, at least 10 percent of the voting power of the controlled foreign corporation).

In addition, the proposal modifies the application of subpart F to PFCs by including foreign base company income of a PFC in the income of U.S. persons without regard to otherwise applicable reductions pursuant to the export trade corporation rules (secs. 970 and 971). This modification to the application of the controlled foreign corporation rules preserves present law in that the PFIC provisions apply in full force to export trade corporations.

It is understood that equity issues have been raised with regard to the application of the PFIC rules to export trade corporations. Accordingly, it would be intended that consideration of this matter would be scheduled at the earliest possible date.

A passive foreign corporation is treated under the proposal as U.S. controlled for this purpose either if it would be treated as a controlled foreign corporation under the rules of subpart F, or if, at any time during the taxable year, more than 50 percent of the vote or value of the corporation's stock was owned directly or indirectly by five or fewer U.S. persons (including but not limited to individuals, and including all U.S. citizens regardless of their residence). Indirect stock ownership under the proposal generally refers to stock ownership through foreign entities within the meaning of section 958(a)(2). In addition, for the purpose of determining whether a foreign corporation is U.S. controlled by virtue of the ownership of more than 50 percent of its stock by five or fewer U.S. persons, the constructive ownership principles of the present-law foreign personal holding company rules generally apply. In the case of pass-through entities such as partnerships, S corporations, estates, and trusts, the constructive ownership principles of the present-law foreign personal holding company rules apply except as provided in regulations. It is contemplated that regulations may modify the constructive ownership rules, for example, in the case of a trust in which the beneficial interests may be contingent, subject to determination or adjustment within the discretion of the trustee, or otherwise variable or indeterminate.

Elective current inclusion.--A U.S. person not subject to the above mandatory current inclusion rules--that is, a U.S. person owning less than 25 percent of the stock in a PFC that is not U.S. controlled--may elect application of those rules. As under current law, the PFC is characterized as a "qualified electing fund" with respect to such a U.S. person. In the application of the elective current-inclusion rules, the passive foreign corporation is treated as a controlled foreign corporation with respect to the taxpayer, and the taxpayer is treated as a U.S. shareholder of the corporation.

For foreign tax credit purposes, amounts included in the taxpayer's gross income under this modified application of the controlled foreign corporation rules are treated as dividends received from a foreign corporation which is not a controlled foreign corporation. Thus, an amount would be treated as a dividend from a noncontrolled section 902 corporation, or as passive income, depending on the shareholder's percentage ownership and status as an individual or a corporation.

The application and operation of the shareholder-level election for treatment as a qualified electing fund generally are the same as under the present-law PFIC rules. It would be intended that, in the case of PFC stock owned through a foreign partnership, a partner-level election for treatment as a qualified electing fund will be permitted (except in the case of a foreign partnership that is subject to the simplified reporting rules available to certain large partnerships under subtitle C of the proposal's simplification provisions).

Mark-to-market method

Less-than-25-percent shareholders of passive foreign corporations that are not U.S.-controlled, and who do not elect current inclusion ("nonelecting shareholders"), are subject under the proposal to one of two methods for taxing the economic equivalent of the PFC's current income: the mark-to-market method or the interest-charge method. The mark-to-market method does not apply to the stock of a U.S. person in any PFC that is U.S. controlled (as discussed above), to the stock of a person choosing qualified electing fund treatment, or to stock of a U.S. person who is a 25-percent shareholder (as defined above).

Under the proposal, nonelecting shareholders of a PFC with marketable stock are required to mark their PFC shares to market annually. Under the mark-to-market method, the U.S. person is required to include in gross income each taxable year an amount equal to the excess (if any) of the fair market value of the PFC stock as of the close of the taxable year over the adjusted basis of the stock. In the event the adjusted basis of the stock exceeds its fair market value, the U.S. person is allowed a deduction for the taxable year equal to the lesser of the amount of the excess or the "unreversed inclusions" with respect to the stock. The proposal defines the term "unreversed inclusions" to mean, with respect to any stock in a passive foreign corporation, the excess (if any) of the total amount of mark-to-market gains with respect to the stock included by the taxpayer for prior taxable years, over the amount of mark-to-market losses with respect to such stock that were allowed as deductions for prior taxable years.

The adjusted basis of stock in a passive foreign corporation is increased by the amount of mark-to-market gain included in gross income, and is decreased by the amount of mark-to-market losses allowed as deductions with respect to such stock. In the case of stock owned indirectly by the U.S. person, such as through a foreign partnership, foreign estate or foreign trust (as discussed below), the basis adjustments for mark-to-market gains and losses apply to the basis of the PFC stock in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFC stock.

All amounts of mark-to-market gain on PFC stock, as well as gain on the actual sale or distribution of PFC stock, are treated as ordinary income. Similarly, ordinary loss treatment applies to the deductible portion of any mark-to-market loss on PFC stock, as well as to any loss realized on the actual sale or other disposition of PFC stock to the extent that the amount of such loss does not exceed the unreversed inclusions with respect to that stock. These loss deductions are treated as deductions allowable in computing adjusted gross income.

The source of any amount of mark-to-market gain on PFC stock is determined in the same manner as if the amount of income were actual gain from the sale of stock in the passive foreign corporation. Similarly, the source of any amount allowed as a deduction for mark-to-market loss on PFIC stock is determined in the same manner as if that amount were an actual loss incurred on the sale of stock in the passive foreign corporation.

Definition of "marketable stock."--The mark-to-market method under the proposal only applies to passive foreign corporations the stock of which is "marketable." PFC stock is treated as marketable if it is regularly traded on a qualified exchange, whether inside or outside the United States. An exchange qualifies for this treatment if it is a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or if the Secretary is satisfied that the requirements for trading on that exchange ensure that the market price on that exchange represents a legitimate and sound fair market value for the stock. It would be intended that the Secretary may adopt a definition of the term "regularly traded" that differs from definitions provided for other purposes under the Code. Further, it would be intended that the Secretary not be bound by definitions applied for purposes of enforcing other laws, including Federal securities laws. Similarly, in identifying

qualified foreign exchanges for these purposes, it would be intended that the Secretary not be required to include exchanges that satisfy standards established under Federal securities laws and regulations. PFC stock is also treated as marketable, to the extent provided in Treasury regulations, if the PFC continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the proposal treats as marketable any stock in a passive foreign corporation that is owned by a RIC that continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value. It is believed that the RIC's determination of PFC stock value for this non-tax purpose would ensure a sufficiently accurate determination of the fair market value of PFC stock owned by the RIC. The proposal also treats as marketable any stock in a passive foreign corporation that is held by any other RIC, except to the extent provided in regulations. It is believed that even for RICs that do not make a market in their own stock, but that do regularly report their net asset values in compliance with the securities laws, inaccurate valuations may bring exposure to legal liabilities, and this exposure may ensure the reliability of the values such RICs assign to the stock they hold in PFCs. However, it would be intended that Treasury regulations will disallow mark-to-market treatment for nonmarketable stock held by any RIC that is not required to perform such a net asset valuation at the close of each taxable year, that does not publish such a valuation, or that otherwise does not provide what the Secretary regards as sufficient indicia of the reliability of its valuations under the relevant circumstances.

Coordination with RIC rules.--The proposal coordinates the application of the mark-to-market method with the tax rules generally applicable to RICs. The proposal treats mark-to-market gain on PFC stock as a dividend for purposes of both the 90-percent investment income test of section 851(b)(2) and the 30-percent short-short limitation of section 851(b)(3). In addition, the proposal permits RICs to determine their mark-to-market gain using a fiscal year ending on October 31 of each year, solely for purposes of determining their ordinary income for purposes of the excise tax on the undistributed income of regulated investment companies (sec. 4982). Reductions in value of the PFC stock between October 31 and the end of the RIC's normal taxable year are treated, to the extent provided in regulations, as occurring in the following taxable year for purposes of computing the RIC's investment company taxable income (sec. 852(b)) and the RIC's earnings and profits (sec. 852(c)).[8]

Marketable stock not directly owned by a U.S. person.--In the case of a controlled foreign corporation

(including a passive foreign corporation that is treated under the proposal as a controlled foreign corporation) that owns or is treated as owning stock in a passive foreign corporation, the mark-to-market method generally is applied as if the controlled foreign corporation were a U.S. person. For purposes of the application of subpart F to the controlled foreign corporation, mark-to-market gains are treated as if they were foreign personal holding company income of the character of dividends, interest, royalties, rents or annuities, and allowable deductions for mark-to-market losses are treated as deductions allocable to that category of foreign personal holding company income. The source of such income or loss, however, is determined by reference to the actual (foreign) residence of the controlled foreign corporation.

For purposes of the mark-to-market method, any stock in a passive foreign corporation that is owned, directly or indirectly, by or for a foreign partnership or foreign trust or foreign estate is treated as if it were owned proportionately by its partners or beneficiaries, except as provided in regulations.[9] Stock in a passive foreign corporation that is thus treated as owned by a person is treated as actually owned by that person for the purpose of applying the constructive ownership rule at another level. In the case of a U.S. person who is treated as owning stock in a passive foreign corporation by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the stock in the passive foreign corporation, as well as any disposition by the person actually owning the stock of the passive foreign corporation, is treated under the proposal as a disposition by the U.S. person of stock in the passive foreign corporation.

<u>Transition to mark-to-market</u>.--The proposal provides certain transition rules for PFC stock that becomes subject to the mark-to-market method--that is, generally, marketable PFC stock with respect to which current inclusion rules do not apply. One method applies in general, another applies to PFC stock held by regulated investment companies, and a third method applies to PFC stock held by individuals who become subject to U.S. tax jurisdiction as the result of a change in residence or citizenship.

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8 Similar rules apply under present law for currency gains of RICs (secs. 4982(e)(5), 852(b)(8), and 852(c)(2)).

9 For this purpose, it would be intended that proportionate ownership will take into account any special or discretionary allocations of the distributions or gains with respect to stock in the passive foreign corporation.

(1) The general rule applies in the case of marketable stock in a PFC that is held by the shareholder on the effective date of the proposal, where the PFC was also a PFIC under present law but was not a qualified electing fund with respect to the shareholder for all post-1986 years in the taxpayer's holding period. Under this general rule, tax is imposed under the proposal's mark-to-market rule on the amount of mark-to-market gain representing the stock's appreciation (if any) in the first post-effective date year. In addition, if the stock has not depreciated in the first post-effective date year, tax may be imposed on the full amount of mark-to-market gain representing the stock's appreciation prior to the effective date, as if the stock had been sold at the end of the last pre-effective-date year and taxed subject to present law's interest-charge method.

If on the other hand the stock has not appreciated during the first post-effective date year, tax is imposed only on the amount of the net mark-to-market gain representing the stock's appreciation between the beginning of the taxpayer's holding period and the last day of the first post-effective date year. In either case, the difference between the fair market value of the PFC stock at the close of the first taxable year under the proposal and the shareholder's adjusted basis in the PFC stock, less the amount of that difference (if any) that represents appreciation during that first taxable year, is treated pursuant to the interest-charge method as having accrued ratably over the shareholder's holding period (ending prior to that first taxable year) in the stock of the PFC.

Both the amount of pre-effective-date appreciation included in gross income (in this case, generally the portion of appreciation treated as having accrued before 1987), and the amount excluded from gross income (but subject to the "deferred tax amount" under the interest-charge method) are treated as an unreversed inclusion for purposes of the application of the mark-to-market method in future years.

In addition, the proposal provides an election to defer the payment of tax (similar to the election for qualified electing funds to defer the payment of tax under present law's section 1294) imposed as a result of the recognition of the pre-effective-date gain. Under the proposal, this election is treated as terminated to the extent a future mark-to-market loss deduction is allocable to the unreversed inclusion for pre-effective-date appreciation. This election is also terminated to the extent of any distribution received by the shareholder that would be an excess distribution under the interest-charge rules if those rules applied to the stock. In either case, it is contemplated that regulations will provide rules for determining the appropriate proportion of the deferred tax for which the extension will terminate. As under present law, any direct or indirect loan by the PFC to the shareholder is treated as a distribution for purposes

of determining the extent to which the extension remains in effect. Also, the extension generally is terminated upon disposition of the PFC stock. To the extent provided in regulations, however, a disposition of PFC stock in a nonrecognition transaction does not terminate the extension; rather, the person acquiring the PFC stock succeeds to the transferor's treatment of the PFC stock under the mark-to-market rules.

(2) Regulated investment companies are subject to a special transition rule for the PFC stock they hold on the proposal's effective date. Instead of applying the interest-charge method to the amount of pre-effective-date appreciation, RICs include the full amount of pre-effective-date appreciation under the mark-to-market method, and pay a separate nondeductible interest charge. No election to defer the payment of tax is available.

(3) In the case of a shareholder of a PFC with marketable stock who becomes subject to the tax jurisdiction of the United States as a result of a change in residence or citizenship, no U.S. tax applies under the mark-to-market method or under the interest-charge method to the appreciation of the stock's value prior to the time that the shareholder becomes subject to the tax jurisdiction of the United States. The proposal implements this rule by treating the greater of (i) the fair market value of the PFC stock at the time that the shareholder enters U.S. tax jurisdiction, or (ii) the shareholder's basis in the PFC stock, as the shareholder's basis in the PFC stock solely for purposes of the mark-to-market method.

Interest-charge method

Nonelecting shareholders[10] of a PFC with stock that is not marketable are subject to the interest-charge method, based on the PFIC interest-charge method that is currently provided in Code section 1291, with certain modifications.

First, although allowable foreign tax credits may reduce a U.S. person's net U.S. tax liability on an excess distribution, the interest charge computed on that excess distribution is computed, under the proposal, without regard to reductions in net U.S. tax liability on account of direct foreign tax credits.

The PFIC provisions of present law, to the extent provided in regulations, impose recognition of gain in the case of a transfer of interest-charge PFIC stock in a

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[10] All citizens (and residents) of the United States are included, irrespective of residence in a U.S. commonwealth or possession.

transaction that would otherwise qualify for the nonrecognition provisions of the Code. The proposal imposes that result as a general rule, except as otherwise provided in Treasury regulations. As noted above, under proposed Treasury regulations nonrecognition provisions may apply to the gain, but only to the extent that the transferee will be subject to the interest-charge method on a subsequent distribution by the PFC or disposition of the PFC stock.

In addition, the proposal requires that proper adjustment be made to the basis of property, held by the U.S. person, through which the U.S. person is treated as owning stock in the passive foreign corporation.

The PFIC provisions of present law apply rules for the attribution of ownership of PFIC stock to U.S. persons, including a rule that attributes PFIC stock owned by a corporation to any person who owns, directly or indirectly, 50 percent or more of the value of the stock of the corporation. Under the proposal, the 50-percent threshold applies not only to stock owned directly or indirectly, but also to stock treated as owned by application of the family attribution rules of the personal holding company provisions (sec. 544 (c)(2)).

The PFIC provisions of present law provide special rules for the application of the interest-charge method in the case of PFIC stock held by an U.S. person through an intermediary entity. These rules describe the dispositions that are treated as dispositions of PFIC stock by the U.S. person, and include rules to eliminate the possibility of double taxation (sec. 1297(b)(5)). The proposal clarifies that, under regulations, these rules apply to any transaction that results in the U.S. person being treated as no longer owning the PFC stock, as well as any disposition of the PFC stock by the entity actually owning the PFC stock. These rules apply regardless of whether the transaction involves a disposition of the PFC stock, and regardless of whether the parties to the transaction include the U.S. person, the entity actually owning the PFC stock, or some other entity. For example, these rules apply to the issuance of additional stock by an intermediary corporation to an unrelated party in a case where, by increasing the total outstanding stock of the intermediary corporation, the transaction causes the U.S. person to fall below the ownership threshold for indirect ownership of the PFC stock. The proposal also clarifies that an income inclusion under the interest-charge method takes precedence over an income inclusion under subpart F resulting from the same disposition. The second clarification ensures that the interest charge is imposed without regard to the structure of the transaction.

Under the proposal, the interest-charge method applies to any stock in a passive foreign corporation unless either the stock is marketable (and therefore the mark-to-market

method applies) as of the time of the distribution or disposition involved, or the stock in the passive foreign corporation was subject to the current inclusion method (under the proposal or under prior law) for each taxable year beginning after December 31, 1986 which includes any portion of the taxpayer's holding period in the PFC stock. In the event that PFC stock, not subject to the current inclusion method, becomes marketable during the taxpayer's holding period, the interest-charge method applies to any distributions and dispositions during the year in which the stock becomes marketable, as well as to the mark-to-market gain (if any) as of the close of that year. In the event that PFC stock was initially marketable, and later becomes unmarketable and subject to the interest-charge method, the taxpayer's holding period in the PFC stock for purposes of the interest-charge method is treated as beginning on the first day of the first taxable year beginning after the last taxable year for which the mark-to-market method applies to the taxpayer's stock in the PFC.

Under the proposal, as under the present-law PFIC rules, stock in a foreign corporation generally is treated as PFC stock if, at any time during the taxpayer's holding period of that stock, the foreign corporation (or any predecessor) is a passive foreign corporation subject to the interest-charge method (current sec. 1297(b)(1)). (This rule is sometimes referred to as the "once-a-PFIC-always-a-PFIC" rule.) Under present law this rule generally does not affect a taxpayer holding stock in a foreign corporation if at all times during the holding period of the taxpayer with respect to the stock when the foreign corporation (or any predecessor) is a PFIC, qualified electing fund treatment applies with respect to the taxpayer. Under the proposal, the similar once-a-PFC-always-a-PFC rule does not apply if during the taxpayer's entire holding period with respect to the stock when the foreign corporation (or any predecessor) is a PFC, either (a) mark-to-market treatment applies, (b) mandatory current inclusion of income applies (either because the corporation is U.S. controlled or because the taxpayer is a 25-percent shareholder), or (c) elective current inclusion of income applies.[11] Thus, for example, a shareholder of a controlled

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[11] In the case of a PFC that was a PFIC prior to the effective date of the proposal, even if the PFC is subject to either mark-to-market treatment or mandatory current inclusion, the once-a-PFC-always-a-PFC rule applies unless the PFIC was subject to elective current inclusion for the entire portion of the taxpayer's holding period prior to the effective date of the proposal. In the case of a PFC that was not a PFIC prior to the effective date of the proposal, the application of the once-a-PFC-always-a-PFC rule is determined without regard to the portion of the taxpayer's holding period prior to the effective date of the proposal.

foreign corporation is subject to current inclusion with respect to all the corporation's income in any year for which the corporation is a PFC, but is subject to current inclusion only to the extent provided under subpart F in any year for which the controlled foreign corporation is not a PFC.

The proposal also provides for full basis adjustment for partnerships and S corporations that own stock in a passive foreign corporation subject to the interest-charge method. Although tax is imposed on a distribution or disposition under the interest-charge method without including the distribution or disposition in gross income, thus precluding the natural basis adjustments for amounts included in gross income, the proposal grants regulatory authority for appropriate basis adjustments to partnerships and S corporations based on the amount of income subject to tax under the interest-charge method and thereby excluded from gross income.

The proposal includes a broad grant of regulatory authority, as does the present-law PFIC statute. In addition, the proposal specifies that necessary or appropriate regulations under the PFC rules may include regulations providing that gross income should be determined without regard to the operation of the interest-charge method for such purposes as may be specified in the regulations. Such regulations may relieve pressure on many aspects of the Code that result from the operation of the interest-charge method other than through gross income. In addition, the proposal specifies that necessary or appropriate PFC regulations may include regulations dealing with changes in residence status or citizenship by shareholders in passive foreign corporations (e.g., a resident alien becoming a nonresident, or a nonresident U.S. citizen renouncing U.S. citizenship). It would be intended that no inference be drawn from this explicit regulatory authority as to the Secretary's authority to issue similar regulations under the authority of the PFIC provisions of present law.

<u>Modification or repeal of other antideferral regimes</u>

While the proposal includes in the passive foreign corporation rules most of the provisions that it preserves from the present-law PFIC, foreign personal holding company, and foreign investment company regimes, the proposal modifies subpart F in one respect to reflect a present-law provision of the foreign personal holding company rules (sec. 553(a)(5)). The proposal treats as foreign personal holding company income for subpart F purposes an amount received under a personal service contract if a person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract. The proposal similarly treats as foreign personal holding company

income for subpart F purposes any amount received from the sale or distribution or disposition of such a contract. This rule applies only if at some time during the taxable year 25 percent or more of the value of the corporation's stock is owned (directly, indirectly, or constructively) by or for the individual who may be designated to perform the services.[12] Income from such personal service contracts is not, however, treated as passive for foreign tax credit purposes.

The proposal repeals the foreign personal holding company provisions, the PFIC provisions (except as modified and preserved as the passive foreign corporation provisions), and the foreign investment company provisions. The proposal also excludes all foreign corporations from the application of the accumulated earnings tax and the personal holding company tax. It is understood that the purposes of all the anti-deferral regimes are adequately served by the passive foreign corporation provisions as set forth in the proposal, in conjunction with the controlled foreign corporation provisions as modified by the proposal.

In addition, the proposal denies installment sales treatment for any installment obligation arising out of a sale of stock in a passive foreign corporation that is subject to the interest-charge regime.

As a conforming amendment to the special rules applicable to RICs holding PFC stock, the proposal confirms that the income of a RIC from either a controlled foreign corporation or a PFC, which income is derived from the active conduct of the business of investing in stocks or securities, is a type of income that counts toward meeting the 90-percent investment income test of section 851(b)(2).

In addition, as a conforming amendment to the elimination of the present-law PFIC rules, distributions from a PFC of amounts that previously were included in a shareholder's income under the elective current-inclusion rules of present law are treated, under the proposal, as previously taxed income under the subpart F rules (sec. 959).

Effective Date

The proposal generally would be effective for taxable years of U.S. persons beginning after December 31, 1992, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

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[12] This rule was included in the definition of foreign personal holding company income for purposes of subpart F prior to the amendments included in the 1986 Act.

The denial of installment sales treatment would be effective for sales or dispositions after December 31, 1992.

The proposal would not affect the determination of the basis of any stock that was acquired from a decedent in a taxable year beginning before January 1, 1993.

2. Treatment of controlled foreign corporations

Present Law

Treatment of controlled foreign corporation earnings

In general

A U.S. shareholder generally treats dividends from a controlled foreign corporation as ordinary income from foreign sources that carries both direct and indirect foreign tax credits. Under look-through rules, the income and credits are subject to those foreign tax credit limitations which are consistent with the character of the income of the foreign corporation.

Several Code provisions result in similar tax treatment of a U.S. shareholder if it either disposes of the controlled foreign corporation stock, or the controlled foreign corporation realizes certain types of income (including income with respect to lower-tier controlled foreign corporations). First, under section 1248, gain resulting from the disposition by a U.S. person of stock in a foreign corporation that was a controlled foreign corporation with respect to which the U.S. person was a U.S. shareholder in the previous five years is treated as a dividend to the extent of allocable earnings.

Second, a controlled foreign corporation has subpart F income when it realizes gain on disposition of stock and, ordinarily, when it receives a dividend. Under sections 951 and 960, such subpart F income may result in taxation to the U.S. shareholder similar (but not identical) to that on a dividend from the controlled foreign corporation. In addition to provisions for characterizing income and credits in these situations, the Code also provides certain rules that adjust basis, or otherwise result in modifying the tax consequences of subsequent income, to account for these and other subpart F income inclusions.

Third, when in exchange for property any corporation (including a controlled foreign corporation) acquires stock in another corporation (including a controlled foreign corporation) controlled by the same persons that control the acquiring corporation, earnings of the acquiring corporation (and possibly the acquired corporation) may be treated under section 304 as having been distributed as a dividend to the seller.

For foreign tax credit separate limitation purposes, a controlled foreign corporation is not treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation and

except as provided in regulations, the recipient of the distribution was a U.S. shareholder in such corporation. The consequence of not being treated as a section 902 corporation is application of the so-called "look-through" rule. That is, dividends paid by such controlled foreign corporation to its U.S. shareholder are characterized for separate limitation purposes by reference to the character of the underlying earnings of the controlled foreign corporation.

Lower-tier controlled foreign corporations

For purposes of applying the separate foreign tax credit limitations, receipt of a dividend from a lower-tier controlled foreign corporation by an upper-tier controlled foreign corporation may result in a subpart F income inclusion for the U.S. shareholder that is treated as income in the same limitation category as the income of the lower-tier controlled foreign corporation. The income inclusion of the U.S. shareholder may carry deemed-paid credits for foreign taxes paid by the lower-tier controlled foreign corporation, and the basis of the U.S. shareholder in the stock of the first-tier controlled foreign corporation is increased by the amount of the inclusion. If, on the other hand, the upper-tier controlled foreign corporation sells stock of a lower-tier controlled foreign corporation, then the gain generally is also included in the income of the U.S. shareholder as subpart F income and the U.S. shareholder's basis in the stock of the first-tier controlled foreign corporation is increased to account for the inclusion, but the inclusion is not treated for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier controlled foreign corporation. Instead it generally is treated as passive income.

If subpart F income of a lower-tier controlled foreign corporation is included in the gross income of a U.S. shareholder, no provision of present law allows adjustment of the basis of the upper-tier controlled foreign corporation's stock in the lower-tier controlled foreign corporation.

Subpart F inclusions in year of disposition

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. shareholders of the corporation on the last day, in that year, on which the corporation is a controlled foreign corporation. In the case of a U.S. shareholder who acquired stock in a controlled foreign corporation during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquirer with respect to that stock. The reduction is the lesser of the amount of dividends with respect to such stock received by other persons during the year or the amount determined by

multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Distributions of previously taxed income

If in a year after the year of a subpart F income inclusion, a U.S. shareholder in the controlled foreign corporation receives a distribution from the corporation, the distribution may be deemed to come first out of the corporation's previously taxed income and, therefore, may be excluded from the U.S. shareholder's income. However, a distribution by a foreign corporation to a domestic corporation of earnings and profits previously taxed under subpart F is treated as an actual dividend, solely for purposes of determining the indirect foreign tax credit available to the domestic corporation (sec. 960(a)(3)).

In addition, the domestic corporation is permitted to increase its foreign tax credit limitation in the year of the distribution of previously taxed earnings and profits in an amount equal to the excess of the amount by which its foreign tax credit limitation for the year of the subpart F inclusion was increased as a result of that inclusion, over the amount of foreign taxes which were allowable as a credit in that year and which would not have been so allowable but for the subpart F inclusion (sec. 960(b)). The increase in the foreign tax credit limitation may not, however, exceed the amount of the foreign taxes taken into account under this provision with respect to the distribution of previously taxed earnings and profits. In order for this rule to apply, the domestic corporation either must have elected to credit foreign taxes in the year of the subpart F inclusion or must not have paid or accrued any foreign taxes in such year, and it must elect the foreign tax credit in the year of the distribution of previously taxed earnings and profits.

Treatment of United States source income earned by a controlled foreign corporation

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the controlled foreign corporation. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

Description of Proposal

Lower-tier controlled foreign corporations

The proposal would allow deemed dividend treatment for gains on dispositions of lower-tier controlled foreign

corporations. Where the lower-tier controlled foreign corporation previously earned subpart F income, the proposal permits the amount of gain taxed to the U.S. shareholder to be adjusted for previous income inclusions. The proposal repeals the limitation on look-through treatment (for foreign tax credit separate limitation purposes) of dividends from controlled foreign corporations to U.S. shareholders out of earnings from periods in which the payor was a controlled foreign corporation, but the dividend recipient was not a U.S. shareholder of the controlled foreign corporation.

Subpart F inclusions in year of disposition

Where a controlled foreign corporation (whether or not it is a lower-tier controlled foreign corporation) earns subpart F income in a year in which a U.S. shareholder sells its stock, in a transaction that does not result in the foreign corporation ceasing to be a controlled foreign corporation, the bill contains statutory language providing for a proportional reduction in the taxation of the subpart F income in that year to the acquiring U.S. shareholder.

Distributions of previously taxed income

Where proceeds from the sale of stock to a controlled foreign corporation that previously has earned subpart F income would be treated as a dividend under the principles of section 304, the proposal expressly permits exclusion of the deemed section 304 dividend from taxation to the extent of the previously taxed earnings and profits of the controlled foreign corporation from which the property was deemed to be distributed. (Appropriate basis adjustments also are permitted to be made.)

Foreign tax credit in year of receipt of previously taxed income

The proposal grants regulatory authority to develop a simplified mechanism for computing indirect foreign tax credits and increases in foreign tax credit limitations resulting upon certain distributions by controlled foreign corporations of previously taxed earnings and profits.

Treatment of United States source income earned by a controlled foreign corporation

The proposal clarifies the effect of a treaty exemption or reduction of the branch profits tax on the determination of subpart F income.

Effective Dates

Lower-tier controlled foreign corporations

The proposal treating gains on dispositions of stock in lower-tier controlled foreign corporations as dividends under section 1248 principles applies to gains recognized on transactions occurring after date of enactment of the bill. The proposal that expands look-through treatment, for foreign tax credit limitation purposes, of dividends from controlled foreign corporations, is effective for distributions after the date of the bill's enactment.

The proposal allowing for regulatory adjustments to U.S. shareholder inclusions, with respect to gains of controlled foreign corporations from dispositions of stock in lower-tier controlled foreign corporations that previously had subpart F income, is effective for determining inclusions for taxable years of U.S. shareholders beginning after December 31, 1992. Thus, the proposal permits regulatory adjustments to an inclusion occurring after the effective date to account for previous subpart F income inclusions occurring both prior to and subsequent to the effective date of the provision.

Subpart F inclusions in year of disposition

The proposal permitting dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year is effective with respect to dispositions occurring after the date of enactment of the provision.

Distributions of previously taxed income

The proposal allowing the Secretary to make regulatory adjustments to avoid double inclusions in cases such as those to which section 304 applies takes effect on the date the proposal is enacted.

Foreign tax credit in year of receipt of previously taxed income

The proposal granting regulatory authority to establish simplified methods for determining the amount of increase in foreign tax credit limitation resulting from a distribution of previously taxed income is effective as of the date of enactment of the proposal.

Treatment of United States source income earned by a controlled foreign corporation

The proposal concerning the effect of treaty exemptions from or reductions of the branch profits tax on the determination of subpart F income is effective for taxable years beginning after December 31, 1986.

3. Translation of foreign taxes into U.S. dollar amounts

Present Law

Translation of foreign taxes

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession (sec. 986(a)(1)).

Redetermination of foreign taxes

For taxpayers who utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual. In certain cases where a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination (or adjustment) of foreign taxes is required. Generally, such an adjustment may be attributable to one of three causes. One such cause would be a refund of foreign taxes. Second, a foreign tax redetermination may be required because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. These first two cases generally give rise to a so-called "section 905(c) regular adjustment." Third, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment giving rise to a so-called "section 905(c) translation adjustment."

Description of Proposal

Translation of foreign taxes

Translation of certain accrued foreign taxes

With respect to taxpayers who take foreign income taxes into account when accrued for purposes of determining the foreign tax credit, the proposal generally permits foreign taxes to be translated at the average exchange rate for the taxable year to which such taxes relate. If tax in excess of the accrued amount is actually paid, such excess amount would be translated using the exchange rate in effect as of the time of payment.

This set of rules does not apply (1) to taxpayers that are not on the accrual basis for determining creditable foreign taxes, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to the extent provided

in regulations, to tax payments denominated in a currency determined to be an inflationary currency in accordance with such regulations. In addition, this set of rules does not apply to, and thus a redetermination of foreign tax is required for, any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate.

Translation of all other foreign taxes

Foreign taxes not eligible for application of the preceding rules generally are translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The proposal grants the Secretary of the Treasury authority to issue regulations that would allow foreign tax payments made by a foreign corporation or by a foreign branch of a U.S. person to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period.

Redetermination of foreign taxes

As revised by the proposal, section 905(c) requires foreign tax redeterminations to occur in three cases: (1) if accrued taxes when paid (in foreign currency) differ from the amounts claimed (in foreign currency) as credits by the taxpayer, (2) if accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, and (3) if any tax paid is refunded in whole or in part. Thus, if at the close of the second taxable year after the close of the accrual year any tax so accrued has not yet been paid, a foreign tax redetermination under section 905(c) is required for the amount of such unpaid tax. That is, the accrual of any tax that is unpaid as of that date would be retroactively denied.

In the case of accrued taxes not paid within the date two years after the close of the taxable year to which such taxes relate, whether or not such taxes were previously accrued, any such taxes if subsequently paid are taken into account for the taxable year in which paid, and no redetermination with respect to the original year of accrual is required on account of such payment. In such a case, those taxes would be translated into U.S. dollar amounts using the exchange rates in effect for the period during which such taxes are paid.

Effective Date

The proposal generally is effective for taxes paid (in the case of taxpayers using the cash basis for determining the foreign tax credit) or accrued (in the case of taxpayers using the accrual basis for determining the foreign tax credit) in taxable years beginning after December 31, 1991. However, with respect to the proposed change to section

905(c), taxes that relate to an earlier year, and are paid within two years after the close of taxpayer's last taxable year beginning before January 1, 1992, are taken into account for the year for which they would be taken into account as determined under current law.

4. Foreign tax credit limitation under the alternative minimum tax

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source and U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, after allocating and apportioning deductions for regular tax foreign tax credit limitation purposes, additional allocations and apportionments generally must be performed in order to compute the AMT foreign tax credit limitation.

Description of Proposal

The proposal permits taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source *regular* taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source *alternative minimum* taxable income to entire alternative minimum taxable income. Foreign source regular taxable income may be used, however, only to the extent it does not exceed entire alternative minimum taxable income. In the event that foreign source regular taxable income does exceed entire alternative minimum taxable income, and the taxpayer has income in more than one foreign tax credit limitation category, it is intended that the foreign source taxable income in each such category generally would be reduced by a pro rata portion of that excess.

The election under the proposal is available only in the first taxable year beginning after December 31, 1992, for which the taxpayer claims an AMT foreign tax credit. A taxpayer will be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit, and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election applies to all subsequent taxable years, and may be revoked only with the permission of the Secretary of the Treasury.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1992.

5. Inbound and outbound transfers

Present Law

Outbound transfers

Corporate nonrecognition provisions

If a U.S. person transfers property to a foreign corporation in connection with certain corporate organizations, reorganizations, or liquidations, the foreign corporation will not, for purposes of determining the extent to which gain is recognized on such transfer, be considered to be a corporation (sec. 367(a)(1)). Various exceptions to the operation of this rule are provided, including a broad grant of authority to provide exceptions by regulation. Since corporate status is essential to qualify for the tax-free organization, reorganization, and liquidation provisions, failure to satisfy the requirements of section 367 could result in the recognition of gain to the participant corporations and shareholders.

Excise tax on transfers to a foreign entity

An excise tax generally applies on transfers of property by a U.S. person to a foreign corporation--as paid-in surplus or as a contribution to capital--or to a foreign estate, trust, or partnership. The tax is 35 percent of the amount of gain inherent in the property transferred, but not recognized for income tax purposes at the time of the transfer (sec. 1491). For income tax purposes, the basis of the property whose appreciation and transfer triggers the tax is not increased to account for imposition of the tax.

The excise tax does not apply in certain cases where the transferee is exempt from U.S. tax under Code sections 501-505 (sec. 1492(1)). In addition, the excise tax does not apply in some cases where income tax rules governing outbound transfers apply, either by their terms or by the election of the taxpayer. Thus, the excise tax does not apply to a transfer described in section 367, or to a transfer not described in section 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of section 367 (sec. 1492(2)).

In addition, a taxpayer may elect (under regulations prescribed by the Secretary) to treat a transfer described in section 1491 as a sale or exchange of the property transferred and to recognize as gain (but not loss) in the year of the transfer the excess of the fair market value of the property transferred over the adjusted basis (for determining gain) of the property in the hands of the transferor (sec. 1057; Treas. Reg. sec. 7.0). To the extent

that gain is recognized pursuant to the election in the year of the transfer, the transfer is not subject to the excise tax, and the basis of the property in the hands of the transferee will be increased by the amount of gain received (sec. 1492(3)).

The excise tax is due at the time of the transfer (sec. 1494(a)). Under regulations, the excise tax may be abated, remitted, or refunded if the taxpayer, after the transfer, elects the application of principles similar to the principles of section 367 (sec. 1494(b)).

Inbound corporate transfers

Section 367(b) provides, in part, that in the case of certain exchanges in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation will be considered to be a corporation except to the extent provided in regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Although it is clear that absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or reorganization into a U.S. corporation leads to avoidance of tax, and in revising section 367(b) Congress noted without disapproval the adoption of IRS positions that would prevent the avoidance of tax in these cases,[1] neither section 367(b) as revised in 1976, nor its predecessors, were drafted in such a way that directly causes tax to be imposed on foreign earnings.

Neither the present temporary regulations nor the recently proposed regulations under section 367(b) mandate a tax based on the accumulated earnings of a foreign corporation that liquidates or reorganizes into a U.S. corporation. The temporary regulations allow the taxpayer to elect treatment of the foreign corporation as a corporation if the tax on earnings is paid. If the taxpayer chooses not to make the election, the foreign corporation is not treated as a corporation under the relevant nonrecognition provision (e.g., sec. 332, 354), but is treated as a corporation for other purposes, such as for purposes of the basis rules (secs. 334, 358, 362), and carryover provisions (sec. 381) (Temp. Treas. Reg. secs. 7.367(b)-5(b) and 7.367(b)-7(c)(2)). The proposed regulations generally require that the foreign corporation be treated as a corporation, and permit the taxpayer to elect either to pay the tax on earnings, or to

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[1] E.g., Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 264 (1976).

pay tax on the gain; but if the latter option is chosen, adjustments must be made to either net operating loss carryovers, capital loss carryovers, or asset bases (Proposed Treas. Reg. sec. 1.367(b)-3(b)(2)).

Description of Proposal

Outbound transfers

The proposal repeals the excise tax on outbound transfers. In its place, the bill requires the full recognition of gain on a transfer of property by a U.S. person to a foreign corporation as paid-in surplus, or as a contribution to capital, or to a foreign estate, trust, or partnership. The Secretary may, however, in lieu of applying this full recognition rule, provide regulations under which principles similar to the principles of section 367 shall apply to any such transfer. Moreover, the Secretary may provide rules under which recognition of gain will not be triggered by section 1491 in cases where the Secretary is satisfied that application of other Code rules (such as those relating to partnerships or trusts) will prevent the avoidance of tax consistent with the purposes of the proposal. Full recognition of gain can also be avoided in the case of a transfer described in section 367. It is anticipated that prior to the promulgation of regulations, the Secretary generally will continue to permit taxpayers to elect the application of principles similar to the principles of section 367, provided the election is made by the time for filing the income tax return for the taxable year of the transfer.

Inbound transfers

Under the proposal, in the case of certain corporate organizations, reorganizations, and liquidations described in section 332, 351, 354, 355, 356, or 361 in which the status of a foreign corporation as a corporation is a condition for nonrecognition by a party to the transaction, income shall be recognized to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. This provision is limited in its application, under the proposal, so as not to apply to a transaction in which the foreign corporation is not treated as a corporation under section 367(a)(1). Thus, the proposal permits the IRS to provide by regulations for recognition of income, without regard to the amount of gain that would be recognized in the absence of the relevant nonrecognition provision listed above. As under current law, such regulations will be subject to normal court review as to whether they are necessary or appropriate for the prevention of avoidance of Federal income taxes.

In addition, the proposal clarifies that rules for

income recognition under section 367(b) may also be applied in a case involving a transfer literally described in section 367(a)(1), where necessary or appropriate to prevent the avoidance of Federal income taxes.[2]

Effective Date

The proposal that amends the outbound rules and repeals the excise tax applies to transfers after date of enactment. The proposal that amends section 367(b) applies to transfers after December 31, 1993.

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2 See Temp. Treas. Reg. sec. 7.367(b)-4(b); Proposed Treas. Reg. sec. 1.367(a)-3(a).

Subpart E. Estate and Gift Tax Provisions

1. Waiver of right of recovery for certain marital deduction property

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to such inclusion from the person receiving the property, unless the surviving spouse directs otherwise by will (sec. 2207A). For this purpose, a will provision specifying that all taxes be paid by the estate is presently sufficient to waive the right of recovery.

The gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income (sec. 2036). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207B). This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

Description of Proposal

Under the proposal, the right of recovery with respect to QTIP would only be waived to the extent that language in the decedent's will or revocable trust specifically so indicates. Thus, a general provision specifying that all taxes be paid by the estate would no longer be sufficient to waive the right of recovery. The proposal also would provide that the right of contribution for property over which the decedent retained enjoyment or the right to income is waived by a specific indication, but specific reference to section 2207B would no longer be required.

Effective Date

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

2. Inclusion in gross estate of certain gifts made within three years of death

Present Law

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The value of the gross estate includes the value of any

previously transferred property if the decedent retained the power to revoke the transfer (sec. 2038). The gross estate also includes the value of any property with respect to which such power is relinquished during the three years before death (sec. 2035). This rule has been interpreted to include in the gross estate certain transfers made from a revocable trust within three years of death.[1] Such inclusion subjects gifts that would otherwise qualify under the annual $10,000 exclusion to estate tax.

Description of Proposal

Under the proposal, a transfer from a trust over which the grantor held the power to revoke would be treated as if made directly by the grantor. Thus, an annual exclusion gift from such trust is not included in the gross estate.

The proposal also revises section 2035 to improve its clarity.

Effective Date

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

3. Definition of qualified terminable interest property

Present Law

A marital deduction is allowed for qualified terminable interest property (QTIP). Property is QTIP only if the surviving spouse has a qualifying income interest for life (e.g., the spouse is entitled to all of the income from the property, payable at least annually). QTIP generally is includible in the surviving spouse's gross estate.

Under proposed Treasury regulations, an income interest may constitute a qualifying income interest for life even if income accumulating between the last distribution date and the date of the surviving spouse's death (the "accumulated income") is not required to be distributed to the surviving spouse or the surviving spouse's estate. See Prop. Treas. Reg. secs. 20.2056(b)-7(c)(1), 25.2523(f)-1(b). Contrary to the proposed regulations, the United States Tax Court has held that in order to satisfy the QTIP requirements, the accumulated income must be paid to the spouse's estate or be subject to a power of appointment held by the spouse. See

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[1] See, e.g., Jalkut Estate v. Commissioner. 96 T.C. 675 (1991) (transfers from revocable trust to permissible beneficiaries of the trust includible in the grantor's gross estate); LTR 9117003 (same).

Estate of Howard v. Commissioner, 91 T.C. 329, 338 (1988), rev'd, 910 F.2d 633 (9th Cir. 1990).

Description of Proposal

Under the proposal, an income interest would not fail to be a qualified income interest for life solely because the accumulated income is not required to be distributed to the surviving spouse. Such income would be includible in the surviving spouse's gross estate.

Effective Date

The proposal would apply to decedents dying, and gifts made, after date of enactment. However, the proposal would not include in the surviving spouse's gross estate property transferred before the date of enactment for which no marital deduction was claimed.

4. Include fractional share of property qualifying for the marital deduction in the gross estate

Present Law

A marital deduction against the estate and gift tax generally is permitted for the value of property passing between spouses. No marital deduction is permitted, however, if, upon termination of the spouse's interest, possession or enjoyment of the property passes to another person (the "terminable interest rule"). Certain exceptions to this rule may apply if the spouse receives a general power of appointment over, or an income interest in, a "specific portion" of property (sec. 2056(b)(5), (6), (7)). The spouse is subject to transfer tax on property over which he or she holds a general power of appointment.

A Treasury regulation defines a "specific portion" to be a fractional or percentage share of a property interest (Treas. Reg. sec. 20.2056(b)-5(c)). Finding this regulation invalid, courts have held that the term "specific portion" includes a fixed dollar amount. See Northeastern Pennsylvania National Bank & Trust Co. v. United States, 387 U.S. 213 (1967); Estate of Alexander v. Commissioner, 82 T.C. 34 (1984), aff'd, No. 8401600 (4th Cir. April 3, 1985). Under the court holdings, appreciation in certain marital deduction property may be includible in neither spouse's estate.

Description of Proposal

Under the proposal, for purposes of the marital deduction, a "specific portion" only would include a portion determined on a fractional or percentage basis. Thus, a trust would not qualify under the exceptions to the

terminable interest rule unless the required income interest and general power of appointment are expressed as a fraction or a percentage of the property. The proposal thereby would reverse the court holdings and would codify the position of the Treasury regulations. The proposal would not generally affect the marital deduction allowed for a pecuniary formula marital deduction bequest. See, e.g., Rev. Rul. 64-19, 1964-1 C.B. 682.

Effective Date

The proposal would generally apply to gifts made, and decedents dying, after date of enactment. The proposal would not apply to a transfer under a will or revocable trust executed before the date of enactment if either (1) on that date the decedent was under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of death, or (2) the decedent dies within three years after the date of enactment. The proposal would apply, however, if the will or trust is amended after the date of enactment in any respect that increases the amount of the transfer qualifying for the marital deduction or alters the terms by which the interest passes.

5. Requirements for qualified domestic trust

Present Law

A deduction generally is allowed for Federal estate tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") denied the marital deduction for property passing to a noncitizen spouse outside a qualified domestic trust ("QDT"). An estate tax is imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust that, among other things, required all trustees be U.S. citizens or domestic corporations. This provision was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to require that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").

Description of Proposal

The proposal would treat a trust created before the enactment of the Omnibus Budget Reconciliation Act of 1990 as satisfying the withholding requirement if its governing instrument requires that all trustees be U.S. citizens or domestic corporations.

Effective Date

The proposal would apply as if included in the Omnibus Budget Reconciliation Act of 1990.

6. Election of special use valuation of farm property for estate tax purposes

Present Law

For estate tax purposes, an executor may elect to value certain real property used in farming or other closely held business operations at its current use value rather than its highest and best use (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

Treasury regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A-8). The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

Under procedures prescribed by the Secretary of the Treasury, an executor who makes the election and substantially complies with the regulations but fails to provide all required information or the signatures of all persons with an interest in the property may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Secretary.

Description of Proposal

The proposal would extend the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to compliance with the Treasury regulations. Thus, the proposal would allow the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. During that time period, the proposal also would allow addition of signatures to a previously filed agreement.

Effective Date

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

7. Income taxation of accumulation trusts

Present Law

In general

A nongrantor trust is treated as a separate taxpayer for Federal income tax purposes. Such trust is generally treated as a conduit with respect to amounts distributed currently and taxed as an individual with respect to undistributed income. The conduit treatment is achieved by allowing the trust a deduction for amounts distributed to beneficiaries during the taxable year to the extent of distributable net income and by including the distributions in the beneficiaries' income.

Distributions of accumulated income

A distribution of previously accumulated income is taxed under the so-called throwback rules, which provide that beneficiaries are taxed on distributions of previously accumulated income from trusts in substantially the same manner as if the income had been distributed in the year received.

Distributions of appreciated property

If property is sold within two years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property is taxed at the contributor's marginal tax rates (sec. 644). In effect, section 644 treats such gains as if the contributor had realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.

Treatment of multiple trusts

Effective March 1, 1984, two or more trusts are treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is the avoidance of Federal income tax (sec. 643(f)). For trusts that were irrevocable as of that date, section 643(f) applies only to subsequent contributions to corpus.

Description of Proposal

The proposal would exempt amounts distributed from domestic trusts after December 31, 1992, from "throwback rules." It also would provide that precontribution gain on property sold by a domestic trust is no longer taxed at the

contributor's marginal tax rates. The proposal would not apply to a trust created before March 1, 1984, unless the taxpayer establishes that the trust would not have been aggregated under the standard contained in section 643(f).

Effective Date

The change in the throwback rules would apply to taxable years beginning after December 31, 1992. The modification in section 644 would apply to sales or exchanges after December 31, 1992.

8. 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, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Under section 2032A of the Code, the executor may elect to value certain "qualified real property" used in farming or another 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.

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). Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party); Williamson v. Commissioner, 93 T.C. 242 (1989) (cash lease to family member).

Description of Proposal

The proposal would provide that the cash lease of specially valued real property by a qualified heir to a "family member" will not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c). For purposes of the proposal, a "family member" would be defined to include a qualified heir's siblings (and their spouses), but would exclude nieces and nephews.

Effective Date

The provision is effective for open taxable years of estates of decedents dying after December 31, 1976.

9. Interest rate on intra-familial loans made in connection with land sales

Present Law

Under section 483 of the Code, a deferred payment contract will generally have unstated interest unless the interest rate provided in the debt instrument is at least equal to the "applicable federal rate" (as determined under section 1274(d)). In determining the amount of unstated interest under section 483, a special six percent rate is substituted for the "applicable federal rate" with respect to certain land sales between related parties (sec. 483(e)).

Two United States Court of Appeals have recently divided as to whether the special six percent "safe-harbor" rate under section 483(e) could be applied in valuing an installment sales contract for estate and gift tax purposes. See Ballard v. Commissioner, 854 F.2d 185 (7th Cir. 1988)(holding that six percent rate under section 483(e) could be used for gift tax purposes); Krabbenhoft v. Commissioner, 939 F.2d 529 (8th Cir. 1991)(holding that section 483(e) did not apply for gift tax purposes).

Description of Proposal

The proposal would provide that section 483(e) would be applicable for gift tax purposes to qualifying related party loans in connection with land transfers.

Effective Date

The proposal would be effective with respect to interest accruing after the date of enactment.

Subpart F. Excise Tax Provisions

A. Motor Fuel Excise Tax Provisions

1. Consolidate provisions imposing diesel and aviation fuel excise taxes

Present Law

Code section 4091 imposes a tax on the sale of diesel and aviation fuel by a "producer." The term producer generally includes refiners, compounders, blenders, and wholesalers who are registered with the Internal Revenue Service. The term also includes persons to whom diesel or aviation fuel has been sold tax-free.

As a backup, Code section 4041 imposes a tax on certain sales or uses of diesel and aviation fuel if a taxable sale of such fuel has not occurred under section 4091.

Description of Proposal

The proposal would combine the diesel and aviation fuel tax provisions currently divided between Code sections 4041 and 4091 into a revised section 4091. The use of diesel and aviation fuel in a taxable use by producers would be taxed under section 4091, and the definition of producer is clarified to include purchasers in tax-reduced sales.

The proposal also would simplify the Code by eliminating two unnecessary provisions, sections 4041(b)(1)(B) and (j) of the Code. These provisions are redundant.

Effective Date

The proposal would be effective for sales or uses on or after January 1, 1993.

2. Permit refund of tax to taxpayer for diesel and aviation fuel resold to certain exempt purchasers

Present Law

As a general matter, purchasers who use tax-paid fuels for an exempt use are entitled to a refund or credit. Purchasers of tax-paid fuels generally are not permitted a refund or credit if they resell the fuels to another person who subsequently uses them in an exempt use.

However, persons who buy and then resell fuel subject to the special motor fuel or gasoline taxes and of certain other articles are permitted a refund or credit (rather than the ultimate user) if they resell the fuel or article for use in the following exempt uses: (1) export, (2) use as supplies

for aircraft or vessels, (3) use by a State or local government, or (4) use by a nonprofit educational organization for its exclusive use.

Description of Proposal

The proposal would allow a refund or credit to taxpayers for diesel and aviation fuel sold tax-paid to persons who resell for any of the exempt uses described above.

Effective Date

The proposal would be effective for sales on or after January 1, 1993.

3. Consolidate tax credit and refund provisions for fuel excise taxes

Present Law

As a general matter, purchasers who use fuels for an exempt use are entitled to a refund if the fuels have been purchased tax-paid. The refund provisions for the fuels excise taxes are found in several sections of the Code.

In general, a purchaser entitled to a refund may file a quarterly refund claim for any of the first three quarters of the purchaser's tax year, if the claim exceeds a threshold dollar amount (with the lowest being $750). The threshold amounts differ for different fuels and different exempt uses and whether quantities are aggregated. A purchaser cannot file a quarterly claim for refund for its fourth quarter, but must file the claim as a credit on that year's income tax return.

There is an expedited procedure for gasohol blenders claiming a refund of part of the excise tax included in the price of the gasoline used for blending into gasohol.

Finally, only an income tax credit, and not a refund, may be claimed for excise taxes on gasoline and special motor fuel used on a farm for farming purposes.

Description of Proposal

The proposal would consolidate the user credit and refund provisions for the fuels excise taxes into one section of the Code, and would combine the three refund procedures for fuels taxes into a uniform refund procedure. The new uniform refund procedure would permit an exempt user to aggregate its refund claims for all fuels taxes and file for a refund in any calendar quarter in which the amount of the aggregate claim exceeds $750. The uniform refund procedure also would permit such a user to file for a refund for its fourth quarter rather than apply for a credit.

The special expedited procedure for gasohol blenders would not be changed.

Effective Date

The proposal would be effective for sales on or after January 1, 1993.

4. Repeal waiver requirement for fuel tax refunds for cropdusters and other fertilizer applicators

Present Law

In general, farmers who use gasoline and aviation fuel on a farm are entitled to a refund of the tax that has been paid on that fuel. Cropdusters and other fertilizer applicators that use gasoline and aviation fuel on a farm are entitled to a refund of the tax paid on that fuel in lieu of the farmer, but only if the owner or operator of the farm waives its right to a refund for such fuel.

Description of Proposal

The proposal would eliminate the waiver requirement for fuels tax refunds for cropdusters and other fertilizer applicators.

Effective Date

The proposal would be effective for fuels purchased on or after January 1, 1993.

5. Authorize exceptions from information reporting for certain sales of diesel and aviation fuel

Present Law

Certain producers and importers and purchasers are required to file information returns for reduced-tax sales of diesel and aviation fuel.

Description of Proposa

The proposal would permit the IRS by regulation to provide exceptions to the mandatory information return requirement for certain sales of diesel and aviation fuel.

Effective Date

The proposal would apply to sales on or after January 1, 1993.

B. Provisions Relating to Distilled Spirits, Wines, and Beer

Present Law

Return of imported bottled distilled spirits

Present law provides that when tax-paid distilled spirits which have been withdrawn from bonded premises of a distilled spirits plant are returned for destruction or redistilling, the excise taxes are refunded (sec. 5008(c)). This provision does not apply to imported bottled distilled spirits, since they are withdrawn from customs custody and not from bonded premises.

Bond for exported distilled spirits

Bond generally must be furnished to the Department of the Treasury when distilled spirits are removed from bonded premises for exportation without payment of tax. These bonds are cancelled or credited when evidence is submitted to the Department of the Treasury that the distilled spirits have been exported (sec. 5175(c)).

Distilled spirits plant records

Distilled spirits plant proprietors are required to maintain records of their production, storage, denaturation, and other processing activities on the premises where the operations covered by the records are carried on (sec. 5207(c)).

Transfers from breweries to distilled spirits plants

Under present law, beer may be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, but only if the brewery is contiguous to the distilled spirits plant (sec. 5222(b)).

Posting of sign by wholesale liquor dealers

Wholesale liquor dealers (i.e., dealers, other than wholesale dealers in beer alone, who sell distilled spirits, wines, or beer to other persons who re-sell such products) are required to post a sign conspicuously on the outside of their place of business indicating that they are wholesale liquor dealers (sec. 5115).

Refund of tax for wine returned to bond

Under present law, when unmerchantable wine is returned to bonded production premises, tax that has been paid is returned or credited to the proprietor of the bonded wine

cellar to which the wine is delivered (sec. 5044). In contrast, when beer is returned to a brewery, tax that has been paid is returned or credited, regardless of whether the beer is unmerchantable (sec. 5056(a)).

Use of ameliorating material in certain wines

The Code contains rules governing the extent to which ameliorating material (e.g., sugar) may be added to wines made from high acid fruits and the product still be labelled as a standard, natural wine. In general, ameliorating material may not exceed 35 percent of the volume of juice and ameliorating material combined (sec. 5383(b)(1)). However, wines made exclusively from loganberries, currants, or gooseberries are permitted a volume of ameliorating material of up to 60 percent (sec. 5384(b)(2)(D)).

Domestically produced beer for use by foreign embassies, etc.

Under present law, domestically produced distilled spirits and wine may be removed from bond, without payment of tax, for transfer to any customs bonded warehouse for storage pending removal for the official or family use of representatives of foreign governments or public international organizations (secs. 5066 and 5362(e)). (A similar rule also applies to imported distilled spirits, wine, and beer.) No such provision exists under present law for domestically produced beer.

Withdrawal of beer for destruction

Present law does not specifically permit beer to be removed from a brewery for destruction without payment of tax.

Records of exportation of beer

Present law provides that a brewer is allowed a refund of tax paid on exported beer upon submission to Department of the Treasury of certain records indicating that the beer has been exported (sec. 5055).

Transfer to brewery of beer imported in bulk

Imported beer brought into the United States in bulk containers may not be transferred from customs custody to brewery premises without payment of tax. Under certain circumstances, distilled spirits imported into the United States in bulk containers may be transferred from customs custody to bonded premises of a distilled spirits plant without payment of tax (sec. 5232).

Description of Proposals

Return of imported bottled distilled spirits

The procedures for refunds of tax collected on imported bottled distilled spirits returned to bonded premises would be conformed to the rules for domestically produced and imported bulk distilled spirits. Thus, refunds would be available for all distilled spirits on their return to a bonded distilled spirits plant.

Bond for exported distilled spirits

For purposes of cancelling or crediting bonds furnished when distilled spirits are removed from bonded premises for exportation, the Department of the Treasury would be authorized to permit records of exportation to be maintained by the exporter, rather than requiring submission to it of proof of exportation in all cases.

Distilled spirits plant records

Distilled spirits plant proprietors would be permitted to maintain records of their activities at locations other than the premises where the operations covered by the records are carried on (e.g., corporate headquarters), provided that the records are available for inspection by the Treasury Department during business hours.

Transfers from breweries to distilled spirits plants

The proposal would allow beer to be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, regardless of whether the brewery is contiguous to the distilled spirits plant.

Posting of sign by wholesale liquor dealers

The requirement that wholesale liquor dealers post a sign outside their place of business indicating that they are wholesale liquor dealers would be repealed.

Refund of tax for wine returned to bond

The proposal would delete the requirement that wine returned to bonded premises be "unmerchantable" in order for tax to be refunded to the proprietor of the bonded wine cellar to which the wine is delivered.

Use of ameliorating material in certain wines

The wine labelling restrictions would be modified to allow any wine made exclusively from a fruit or berry with a natural fixed acid of 20 parts per thousand or more (before any correction of such fruit or berry) to contain a volume of

ameliorating material not in excess of 60 percent.

Domestically produced beer for use by foreign embassies, etc.

The proposal would extend to domestically produced beer the present-law rule applicable to domestically produced distilled spirits and wine (and imported distilled spirits, wine, and beer) which permits these products to be withdrawn from the place of production without payment of tax for the official or family use of representatives of foreign governments or public international organizations.

Withdrawal of beer for destruction

The proposal would allow beer to be removed from a brewery without payment of tax for purposes of destruction, subject to Treasury Department regulations.

Records of exportation of beer

The proposal would repeal the requirement that proof of exportation be submitted to the Treasury Department in all cases as a condition of receiving a refund of tax. This proof would continue to be required to be maintained at the exporter's place of business.

Transfer to brewery of beer imported in bulk

The proposal would extend the present-law rule applicable to distilled spirits imported into the United States in bulk containers to beer imported into the United States in bulk containers, so that imported beer could, subject to Treasury regulations, be withdrawn from customs custody for transfer to a brewery without payment of tax.

Effective Date

These provisions of the proposal generally would be effective beginning 180 days after date of the bill's enactment. The proposal deleting the requirement that wholesale liquor dealers post a sign outside their place of business would be effective on the date of the bill's enactment.

C. Other Excise Tax Provisions

1. Authority for IRS to grant exemptions from registration requirements

Present Law

Under section 4222, certain sales of articles subject to Federal excise taxes may not be made without payment of tax under section 4121 unless the manufacturer, the first purchaser, and the second purchaser (if any) are all registered under regulations prescribed by the Secretary.

Description of Proposal

The proposal would revise section 4222(a) so that certain sales of articles subject to Federal excise taxes would not be made without payment of tax under section 4221 to any person who is required by the Secretary to be registered but who is not so registered. This would allow the Secretary to provide exemption from registration requirements for certain classes of taxpayers.

Effective Date

The proposal would apply to sales after the 180th day after the date of enactment.

2. Repeal temporary reduction in tax on piggyback trailers

Present Law

Piggyback trailers and semitrailers sold within the 1-year period beginning on July 18, 1984 were permitted a temporary reduction in the retail excise tax on trailers.

Description of Proposal

The proposal would repeal the temporary reduction in tax on piggyback trailers as "deadwood."

Effective Date

The proposal would be effective on the date of enactment.

3. Expiration of excise tax on deep seabed minerals

Present Law

Background

The Deep Seabed Mineral Resources Act (the "Resources

Act," P.L. 96-283), one title of which was the Deep Seabed Hard Mineral Removal Tax Act of 1979 (the "Tax Act"), was enacted into law on June 28, 1980 to encourage the successful negotiation of an international deep seabed treaty by the United Nations Conference on the Law of the Sea (a U.N. international deep seabed treaty).

The Tax Act would impose an excise tax on the removal from the deep seabed of certain hard mineral resources pursuant to a deep seabed permit issued under the Resources Act. In general, a deep seabed permit issued under the Resources Act would authorize its holder to engage in commercial recovery activities with respect to hard mineral resources on or under deep seabeds. No such permits have been issued.

The Tax Act was scheduled to terminate on the earlier of the date on which a U.N. international deep seabed treaty took effect with respect to the United States, or June 28, 1990 (10 years after the date of enactment of the Tax Act). Since the United States did not sign the treaty, the excise tax provisions expired on June 28, 1990.

Description of Proposal

The proposal would delete the deep seabed hard minerals excise tax provisions as "deadwood."

Effective Date

The proposal would be effective on the date of enactment.

4. Firearms excise tax exemption for custom gunsmiths

Present Law

Present law imposes an 11-percent excise tax on the manufacturing (or importing) of rifles and shotguns and on ammunition (shells and cartridges), and also imposes a 10-percent excise tax on pistols and revolvers (sec. 4181).

Revenues from these taxes are appropriated, in the fiscal year following receipt, to the Federal Aid to Wildlife Program for support of State wildlife programs.

Description of Proposal

The proposal would exempt small manufacturers and importers from the 11-percent excise tax on firearms (rifles and shotguns) and ammunition and the 10-percent excise tax on pistols and revolvers, if such manufacturer or importer manufactures or imports less than 50 such articles per year.

Effective Date

The proposal would be effective for articles sold after September 30, 1983. In the case of any taxable year ending before the date of enactment, the period for claiming a credit or refund of any overpayment of tax resulting from the proposed exemption from tax shall not expire before one year after the date of enactment.

5. Exemption for certain ferries from excise tax on ship passenger departures

Present Law

An excise tax of $3 per passenger is imposed on ship passenger departures on a "covered voyage." A covered voyage includes transportation on (1) a commercial passenger vessel which extends over one or more nights, or (2) a commercial vessel transporting passengers engaged in gambling aboard the vessel beyond the territorial waters of the United States (i.e., more than 3 miles from shore) during which passengers embark or disembark the vessel in the United States. The latter circumstances includes such vessels that leave a U.S. port and return the same day.

The tax does not apply to either (1) a voyage on any vessel owned or operated by the United States or a State or local government (e.g., State or local government ferry boats), or (2) a voyage of less than 12 hours between two U.S. ports. A passenger vessel is any vessel having a berth or stateroom accommodations for more than 16 passengers. The tax is imposed only once on a passenger's covered voyage--either upon embarking or disembarking.

The tax on ship passengers was enacted in the Omnibus Budget Reconciliation Act of 1989, effective on January 1, 1990. Revenues from this tax go to the General Fund of the Treasury.

Description of Proposal

The proposal would expand the current exemption from the ship passenger tax for voyages of less than 12 hours between two U.S. ports to also include ferry boat voyages of less than 12 hours between a port in the United States and a port outside the United States. For this purpose, the term "ferry boat" means any vessel if normally no more than 50 percent of the passengers on any voyage of such vessel return to the port where such voyage began on the first return of such voyage to such port.

Effective Date

The proposal generally would apply to voyages beginning after December 31, 1989. However, there would be no refunds of tax paid; and if tax has been collected, it would have to be remitted to the Government.

6. Application of aircraft fuels excise tax or passenger/freight taxes to certain business aircraft

Present Law

Fuels taxes are imposed on fuels used by "noncommercial aviation" aircraft. For aviation gasoline, the tax is 15 cents per gallon, and for nongasoline (jet) fuels, the tax is 17.5 cents per gallon. "Noncommercial aviation" means the use of an aircraft other than in a business of transporting persons or property for compensation or hire. The term also includes the use of an aircraft which is "properly allocable" to any transportation exempt from the air passenger or air freight taxes under sections 4281 of 4282.

Section 4281 exempts small aircraft (maximum certificated takeoff of 6,000 pounds or less) from the air passenger and air freight taxes, unless operated on an established line. Under section 4282, the air passenger and air freight taxes do not apply to transportation by air for other members of an "affiliated group" (as defined in sec. 1504(a), without any exclusions under sec. 1504(b)). In such cases where the air passenger or air freight taxes do not apply, the aircraft is subject to the fuels tax applicable to noncommercial aviation.

Description of Proposal

The proposal would clarify the application of the aviation excise taxes to business aircraft used by corporate affiliated groups to require the Internal Revenue Service to apply the taxes on a flight-by-flight basis for an affiliated group as for a stand alone corporation.

Effective Date

The proposal would be effective on the date of enactment.

Subpart G. Tax-Exempt Bond Provisions

Overview

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (sec. 103).

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (a) a private business use and payment test or (b) a private loan restriction. However, interest on private activity bonds is not taxable if (a) the financed activity is specified in the Code and (b) at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private activity bonds) for the interest on their bonds to be excluded from gross income.

1. Simplification of arbitrage rebate requirement for governmental bonds

Present Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance.

This six-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of five percent or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Description of Proposal

The $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement would be deleted. Thus, if at least 95 percent of the

proceeds of these bonds were spent within six months after their issuance, and the remainder were spent within one year, the six-month exception would be deemed to be satisfied.

Effective Date

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

2. Simplification of compliance with 24-month arbitrage rebate exception for construction bonds

Present Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally owned property.

This exception is satisfied only if the available construction proceeds of the issue are spent at least at specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund, a bona fide debt service fund, or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating if they fail to satisfy the exception's spending requirements.

Description of Proposal

The proposal would exempt earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the penalty requirement of the 24-month exception if the spending requirements of that exception were otherwise satisfied.

Effective Date

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

3. Simultaneous issuance of certain discrete issues not aggregated

Present Law

In certain cases, the Treasury Department treats multiple issues of tax-exempt bonds paid from substantially the same source of funds as a single issue in applying the

Code's tax-exempt bond restrictions when the bonds are issued within a relatively short period of time.

Description of Proposal

The proposal would provide that discrete issues of governmental bonds issued simultaneously will not be treated as a single issue in cases where one of the issues is a tax or revenue anticipation note (TRAN) reasonably expected to satisfy the arbitrage rebate safe harbor of Code section 148(f)(4)(B)(iii).

Effective Date

The proposal would apply to bonds issued after the date of enactment; no inference language would be included with respect to bonds issued on or before that date.

4. Expand exception to pro rata disallowance of bank interest expense related to investment in tax-exempt bonds

Present Law

Banks and other financial institutions generally are denied a deduction for the portion of their interest expense (e.g., interest paid to depositors) that is attributable to investment in tax-exempt bonds acquired after August 7, 1986. This disallowance is computed using a pro-rata formula that compares the institution's average adjusted basis in tax-exempt bonds acquired after that date with the average adjusted basis of all assets of the institution.

An exception to the pro-rata disallowance rule is permitted for governmental bonds and qualified 501(c)(3) bonds issued by or on behalf of governmental units that issue no more than $10 million of such bonds during a calendar year (the "small-issuer exception").

Description of Proposal

The proposal would increase from $10 million to $25 million the amount of governmental and qualified 501(c)(3) bonds that an entity may issue annually while qualifying those bonds for the small-issuer exception to the general bank interest disallowance rule.

The proposal also would provide that pooled financing tax-exempt bonds (other than private activity bonds) may qualify for the small-issuer exception if--

(a) all of the proceeds of the pooled financing bonds (net of issuance costs associated with the bonds) were used exclusively to acquire from the issuer thereof bonds ("acquired bonds") eligible for the small-issuer exception,

(b) the acquired bonds were not designated under section 265(b)(3)(B)(i)(III) as "bank qualified" for purposes of the small-issuer exception;[1]

(c) the weighted average maturity of the pooled financing bonds did not exceed the weighted average maturity of the acquired bonds; and

(d) the issuer of the pooled financing bonds designated those bonds as "bank qualified" under section 265(b)(3)(i)(B)(III).

Effective Date

The proposal would be effective for bonds issued and acquired in calendar years beginning after December 31, 1992.

5. Modification of rules governing qualified 501(c)(3) bonds

Present Law

Interest on State and local government bonds generally is excluded from income if the bonds are issued to finance direct activities of these governments (sec. 103). Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in Code section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business (sec. 141(e)(1)(G)).

Before enactment of the Tax Reform Act of 1986, States and local governments and section 501(c)(3) organizations both were defined as "exempt persons," under the Code bond provisions, and their bonds generally were subject to the same requirements. As exempt persons, section 501(c)(3) organizations were not treated as "private" persons, and their bonds were not "industrial development bonds" or "private loan bonds" (the predecessor categories to current private activity bonds).

Description of Proposal

The proposal would change the tax-exempt bond provisions of the Code to conform generally the treatment of bonds for

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[1] The acquired bonds are taken into account in determining how many bonds are reasonably expected to be issued by the borrowers from the pool in the calendar year in which they are issued.

section 501(c)(3) organizations to that provided for bonds issued to finance direct State or local government activities. First, the concept of an "exempt person" that existed in the bond provisions before 1986, would be reenacted.

Second, present Code section 145, which establishes additional restrictions on qualified 501(c)(3) bonds, would be repealed, along with the restriction on bond-financed costs of issuance for section 501(c)(3) organization bonds (sec. 147(h)). This would eliminate the 150-million-per-organization limit on nonhospital bonds for section 501(c)(3) organizations.

Finally, the proposal would retain certain specialized restrictions on bonds for section 501(c)(3) organizations: (a) the requirement that existing residential rental property acquired by a section 501(c)(3) organization in a tax-exempt-bond-financed transaction satisfy the same low-income tenant requirements as similar housing financing for for-profit developers; (b) the present-law maturity limitations applicable to bonds for section 501(c)(3) organizations, and the public approval requirements applicable generally to private activity bonds; and (c) the penalties on changes in use of tax-exempt-bond-financed section 501(c)(3) organization property to a use not qualified for such financing.

Effective Date

The proposal would apply to bonds issued after December 31, 1992.

6. Authority for Treasury Department to exempt certain taxpayers from tax-exempt interest reporting requirement

Present Law

Present law requires all individuals to report on their income tax returns the amount of interest on State and local government bonds they receive.

Description of Proposal

The proposal would authorize the Treasury Department to provide exceptions to the requirement that taxpayers report interest on State and local government bonds on their Federal income tax returns in cases where the Secretary determines that such information is not useful to the administration of the tax laws.

Effective Date

The proposal would be effective for taxable years

beginning after the date of enactment.

7. Bonds for the United Nations

Present Law

Interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units. Present law also excludes the interest on State and local government bonds ("private activity bonds") when a governmental unit incurs debt as a conduit to provide financing for private parties, if the financed activities are specified in the Internal Revenue Code (the "Code"). Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

Private activity bonds are bonds (1) more than 10 percent of the proceeds of which satisfy a private business use and payment test, or (2) more than five percent ($5 million, if less) of the proceeds are used to finance loans to persons other than State or local governmental units.

Under the tax-exempt bond rules, all persons and entities other than states and local governments are treated as private parties, eligible for financing only if specifically authorized. No such authorization exists for the United Nations, other international organization or any other foreign government entity.

Description of Proposal

The proposal would authorize the issuance by a State or local government of tax-exempt private activity bonds when at least 95 percent of the net proceeds will be used to finance the construction or acquisition of office buildings (and functionally related and subordinate land) for use by the United Nations and its agencies and instrumentalities. These bonds would be subject to the State private activity bond volume limit and all other private activity bond rules (except the rehabilitation requirement on acquisition of existing property).

Effective Date

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

8. Repeal of expired provisions

Present Law

Present law includes two special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. This exception applied only to bonds issued before January 1, 1989.

Description of Proposal

These special exceptions would be deleted as "deadwood."

Effective Date

The proposal would be effective on the date of enactment.

9. Expand Treasury Department regulatory authority to integrate arbitrage rebate and yield restriction requirements

Present Law

In general

Interest on State and local government bonds generally is tax-exempt. Interest is not tax-exempt if the bonds are arbitrage bonds. Arbitrage bonds are bonds more than a minor portion of the proceeds of which is invested at a yield that is materially higher than the bond yield during periods other than prescribed "temporary periods." (Exceptions are provided for, *inter alia*, proceeds such as those invested in a reasonably required reserve or replacement fund.)

Rebate requirement

In general, arbitrage profits earned on investments unrelated to the governmental purpose for which tax-exempt bonds are issued must be rebated to the Federal Government. Because little or no profits are earned other than during temporary periods, this requirement primarily affects earnings during such periods and earnings on such specially treated proceeds as those invested as part of a reasonably required reserve or replacement fund (which are not subject to yield restriction).

For certain governmental and qualified 501(c)(3) bonds issued for construction projects, a special penalty alternative may be elected in lieu of complying with the rebate requirement. Under this elective regime, penalties are imposed unless set expenditure targets are met at six-month intervals. These expenditure targets are:

(1) at least 10 percent of the available construction

proceeds of the bond issue must be spent within six months after the bonds are issued;

(2) at least 45 percent of those proceeds must be spent within 12 months after the bonds are issued;

(3) at least 75 percent of those proceeds must be spent within 18 months after the bonds are issued; and

(4) 100 percent (less certain allowable retainage) of those proceeds must be spent within two years after the bonds are issued.

Temporary periods

Regulatory temporary periods

In general, Treasury Department regulations prescribe the applicable temporary periods for bond proceeds. For most bonds, the initial temporary period is three years from the date on which the bonds are issued. An issuer qualifies for this unrestricted investment period only if the issuer reasonably expects to satisfy three tests:

(1) Expenditure test.--At least 85 percent of the spendable proceeds of the issue must be expected to be spent within three years after the bonds are issued.

(2) Time test.--A substantial binding commitment to commence with the project to be financed must be entered into within six months after the bonds are issued.

(3) Due diligence test.--After the binding commitment is entered into, work to complete the project (and expenditure of proceeds) must proceed with due diligence.

Treasury Department regulations also establish shorter temporary periods for special types of proceeds (e.g., loan repayments) and types of bonds (e.g., tax and revenue anticipation notes).

Statutory temporary periods

The Code provides specific temporary periods in three cases. First, the initial temporary period on pooled financing bonds is limited to six months, and the temporary period on repayments of loans financed with such bonds is limited to three months.[2] Pooled financing bonds are bonds

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2 This six-month period is increased to two years in the case of construction bonds subject to the special expenditure (Footnote continued)

the proceeds of which are to be used to make loans to two or more persons.

Second, the Code provides that the initial temporary period for bonds that are advance refunded terminates no later than the date on which the refunding occurs. Third, the Code limits the initial temporary period on advance refunding bonds to 30 days.

Proposed Treasury Department regulations

On May 18, 1992, the Treasury Department issued proposed regulations which would allow most regulatory temporary periods to be extended indefinitely if (1) the bond proceeds were expended, determined after the fact, in a manner that actually qualified the bonds for the temporary period claimed by the issuer, and (2) all arbitrage profits on the bond issue were rebated to the Federal Government. For example, the three-year initial temporary period described above could be extended if the expenditure, time, and due diligence tests were actually complied with and arbitrage profits were rebated.

The proposed regulations do not apply to the three types of bonds for which statutory temporary periods are prescribed. Additionally, the proposed Treasury Department regulations do not to apply to construction bond issues for which the penalty alternative to the rebate requirement is elected.

Description of Proposal

The proposal would provide the Treasury Department with authority to waive by regulation most statutory tax-exempt bond yield restriction requirements, provided that all arbitrage profits on the bond issue are rebated to the Federal Government. This authority would not extend to either (1) yield restriction of the proceeds of bonds involved in advance refunding transactions or (2) construction bond issues for which the special three-percent penalty-in-lieu-of-rebate penalty is elected.

Provisions, such as "look-back" requirements, based on actual expenditures of bond proceeds, may be imposed by the Treasury as a condition to waiving otherwise applicable yield restriction requirements in order to preclude earlier or larger than necessary issuance of tax-exempt bonds or other abuse in this area.

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[2](continued)
targets, described above, regardless of whether the issuer elects the penalty alternative to the rebate requirement.

Effective Date

The proposal is effective on the date of enactment, for bonds issued after August 15, 1986, but only with respect to earnings accrued after the date of enactment.

Subpart H. Insurance Provisions

1. Treatment of certain insurance contracts on retired lives

Present Law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

Special rules are provided in the case of a variable contract. Under these rules, the reserve for a variable contract is adjusted by (1) subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and (2) adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying a variable contract is adjusted for appreciation or depreciation to the extent the reserve is adjusted.

Description of Proposal

The proposal would provide that a variable contract is to include a contract that provides for the funding of group term life or group accident and health insurance on retired lives if: (1) the contract provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset account of the company; and (2) the amounts paid in, or the amounts paid out, under the contract reflect the investment return and the market value of the segregated asset account underlying the contract. Thus, the reserve for such a contract and the basis of each asset underlying the contract are to be adjusted in accordance with the special rules for variable contracts.

Effective Date

The proposal would apply in taxable years beginning after December 31, 1991.

2. Treatment of modified guaranteed contracts

Present Law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. The net surrender value of a contract is the cash surrender value reduced by any surrender penalty, except that any market value adjustment required on surrender is not taken into account. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

In general, assets held for investment are treated as capital assets. Any gain or loss from the sale or exchange of a capital asset is treated as a capital gain or loss and is taken into account for the taxable year in which the asset is sold or exchanged.

Description of Proposal

The proposal would apply three special rules to modified guaranteed contracts issued by life insurance companies. First, in determining the amount of the reserve for a modified guaranteed contract, any market value adjustment that is required on surrender of the contract is to be taken into account in calculating the net surrender value of the contract. Second, any gain or loss with respect to any asset that is held as part of a segregated account underlying a modified guaranteed contract is treated as ordinary gain or loss. Third, any such asset that is held as of the close of any taxable year generally is treated as sold for its fair market value on the last business day of the taxable year and any gain or loss is required to be taken into account for such taxable year (the "mark-to-market requirement").

In determining the Federally prescribed reserve with respect to a modified guaranteed contract, an interest rate is to be determined under Treasury regulations that is a current market rate, is determined annually, is appropriate for modified guaranteed contracts and that is designed to approximate actual portfolio yield on the assets underlying the contract. Prior to the issuance of such regulations, present law with respect to the interest rate in determining Federally prescribed reserves is retained.

A modified guaranteed contract is defined as any life insurance contract or annuity contract, or any pension plan contract (other than a life, accident, or health, property, casualty, or liability contract), that is not a variable

contract and that meets certain requirements, including the requirements that all or a part of the amounts received under the contract must be allocated to a segregated asset account, and that reserves for the contract are valued at market for annual statement purposes.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1991. A taxpayer that is required to (1) change its calculation of reserves to take into account market value adjustments and (2) mark to market its segregated assets in order to comply with the requirements of the provision is treated as having initiated changes in method of accounting and as having received the consent of the Treasury Department to make such changes.

The section 481(a) adjustments required by reason of the changes in method of accounting are to be combined and taken into account as a single net adjustment for the taxpayer's first taxable year beginning after December 31, 1991.

Subpart I. Miscellaneous Provisions

1. Increase transfer to the Reforestation Trust Fund

Present Law

The Secretary of the Treasury is required to transfer receipts from certain import duties on plywood and lumber to the Reforestation Trust Fund in maximum amounts of $30 million for each fiscal year. In addition, the Trust Fund earns interest on investments of any cash balance. Monies in the Reforestation Trust Fund are to be used to supplement Congressional appropriations for reforestation and timber stock improvement in publicly owned national forests.

Description of Proposal

The proposal would increase from $30 million to $45 million the maximum amount that may be transferred to the Reforestation Trust Fund for any fiscal year. Of the additional $15 million, $14 million would be allocated for qualifying expenditures in California and Oregon.

Effective Date

The proposal would be effective for the 1993 Federal fiscal year and thereafter.

2. Private foundation common investment fund

Present Law

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

Section 501(f) provides that an organization is treated as organized and operated exclusively for charitable purposes if it is comprised solely of members that are educational organizations and is organized and operated solely to collectively invest in stocks and securities on behalf of its 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 upon a vote of members holding a majority of interest in the account managed by such advisor; and (5) the organization is organized and operated solely to collectively invest in stocks and securities on behalf of its members.

A cooperative service organization meeting the criteria of the proposed modification would be subject to the present-law excise tax provisions applicable to private foundations (e.g., sec. 4941 rules governing self-dealing), other than sections 4940 and 4942. In addition, each member's allocable share (whether or not distributed) of the capital gain net income and gross investment income of the organization (and allocable share of expenses) for any taxable year would be treated, for purposes of the excise tax imposed under present-law section 4940, as capital gain net income and gross investment income (and expenses) of the member for the taxable year of such member in which the taxable year of the organization ends.

Effective Date

The proposal would apply to taxable years ending on or after December 31, 1992.

3. Determinations of gas produced from qualifying sources under the nonconventional fuels production credit

Present Law

Nonconventional fuels are eligible for a production credit equal to $3 per barrel or Btu oil barrel equivalent. Qualified fuels must be produced domestically from a well drilled, or a facility placed in service, before January 1, 1993. The production credit is available for qualified fuels sold before January 1, 2003.

Qualified fuels include (1) oil produced from shale and tar sands, (2) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass (i.e., any organic material other than oil, natural gas, or coal (or any product thereof)), and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.

As a general rule, the determination of whether any gas is produced from geopressured brine, Devonian shale, coal seams, or a tight formation is made in accordance with section 503 of the Natural Gas Policy Act of 1978 (the "NGPA"). Under section 503 of the NGPA, if any State or Federal agency makes any final determination that a well produces certain "high-cost natural gas," that determination is applicable unless it is reversed by the Federal Energy Regulatory Commission (FERC) under special procedures established by the NGPA.

Under the regulatory authority granted to it by the NGPA, FERC has furnished definitions of certain types of high-cost natural gas, including definitions of natural gas produced from geopressured brine, occluded natural gas produced from coal seams, natural gas produced from Devonian shale, and gas produced from a tight formation.

In 1989, the Natural Gas Wellhead Decontrol Act was enacted. That Act, among other things, repealed FERC's determination review responsibility under section 503 of the NGPA. FERC has announced in Order No. 539 that it will continue to process well determinations received by June 30, 1993 if they are filed with jurisdictional agencies by December 31, 1992.

Description of Proposal

With respect to determinations required under the Internal Revenue Code of whether gas is produced from geopressured brine, Devonian shale, coal seams, or from a tight formation, in the event that such a determination is not made by the Federal Energy Regulatory Commission in

accordance with section 503 of the Natural Gas Policy Act of 1978 due to the expiration of that statute through enactment of the Natural Gas Wellhead Decontrol Act of 1989, the proposal would require the Secretary of Treasury to make such a determination. For this purpose, the proposal would mandate that any such determination by the Treasury Department be made using the guidelines set forth in section 503 of the Natural Gas Policy Act of 1978 prior to its repeal.

In addition, the proposal would clarify that for purposes of the nonconventional fuels production credit, the definitions of gas produced from geopressured brine, Devonian shale, coal seams, or from a tight formation would be as established by the Federal Energy Regulatory Commission under the Natural Gas Policy Act of 1978 prior to repeal of provisions of that statute relating to such definitions.

Effective Date

With respect to well and formation determinations required to be made by the Treasury Department, the proposal would be effective for determinations with respect to which no such determination is made by the Federal Energy Regulatory Commission as a result of the repeal of section 503 of the Natural Gas Policy Act of 1978. The proposed modification clarifying the definitions of certain qualifying fuels would be effective after December 31, 1992.

IX. OTHER REVENUE PROVISIONS

A. Educational Savings Bond Provisions

Present Law

Code section 135 provides that interest income earned on a qualified U.S. Series EE savings bond issued after December 31, 1989, is excludible from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[1] "Qualified higher education expenses" include tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible educational institution. A taxpayer cannot qualify for the interest exclusion by paying for the education expenses of another person (such as a grandchild or other relative) who is not a dependent of the taxpayer.

The exclusion provided by section 135 is phased out for certain higher-income taxpayers. A taxpayer's AGI for the year the bond is redeemed (not the year the bond was issued) determines whether or not the phaseout applies. For taxpayers filing a joint return, the phaseout range is for AGI between $60,000 and $90,000 (adjusted for inflation). For single taxpayers and heads of households, the phaseout range is for AGI between $40,000 and $55,000 (adjusted for inflation).

To prevent taxpayers from effectively avoiding the income phaseout limitation (through the issuance of bonds directly in the child's name), section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

The interest rate on Series EE savings bonds varies, depending on how long the bonds are held. The interest rate on such bonds held for more than five years is based on the market rate for Treasury outstanding obligations with five years to maturity. Bonds held for less than five years earn interest on a fixed, graduated scale (generally below current rates on comparable Treasury instruments). Interest earned on Series EE bonds is paid when the bonds are redeemed.

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[1] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by a taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount.

Description of Proposal

The proposal would expand the definition of "qualified higher education expenses" under section 135 to include tuition and required fees paid by a taxpayer for the enrollment or attendance of any individual at an eligible educational institution (not simply dependents).

The proposal also would repeal the present-law AGI phaseout limitation under section 135 (and the related rule requiring that bonds be issued to a person who is at least 24 years old). Thus, interest earned on a Series EE savings bond would not be subject to tax regardless of the taxpayer's AGI during the year the bond is redeemed if, during that year, the taxpayer pays for qualified education expenses of any individual and the education expenses exceed the proceeds (principal plus interest) received upon redemption.

Effective Date

The proposal would apply to U.S. Series EE savings bonds issued after December 31, 1989, and redeemed after December 31, 1992.

B. Exclusion from Gross Income for Amounts Paid Under a Life Insurance Contract by Reason of Terminal Illness

Present Law

Under present law, gross income does not include amounts received under a life insurance contract if the amounts are paid by reason of the death of the insured.

Description of Proposal

The proposal would extend the present-law exclusion for life insurance proceeds to amounts paid to an individual under a life insurance contract if the insured under the contract is terminally ill.

An insured would be considered terminally ill for this purpose if the insured has been certified by a licensed physician as having an illness or physical condition that can reasonably be expected to result in death in 12 months or less.

The proposal would clarify that, for purposes of the provisions relating to the taxation of life insurance companies, a qualified terminal interest rider would be treated as life insurance. A qualified terminal interest rider means any rider or addendum, or other provision of, a life insurance contract that provides for payments to an individual in the event of terminal illness.

The proposal would also provide that applicants for, or recipients of, benefits under certain public assistance programs would not be required to take into account the right to receive accelerated death benefits in determining eligibility for such benefits.

Effective Date

The proposal generally would be effective for taxable years beginning after December 31, 1989. The portion of the proposal treating qualified terminal illness riders as life insurance for insurance company tax purposes would be effective for taxable years beginning before, on, or after December 31, 1989. The portion of the proposal relating to the effect of the availability of life insurance benefits in the event of terminal illness on eligibility for public assistance benefits would be effective on January 1, 1990.

C. Offset losses against gains on the sale of a principal residence

Present Law

Under present law, a loss on the sale of a personal residence is not deductible.

Description of Proposal

The proposal would provide that gains that would be recognized on the sale or exchange of a principal residence of a taxpayer are reduced (but not below zero) by the aggregate of the losses sustained by the taxpayer on the sale or exchange of prior principal residences of the taxpayer that were not previously taken into account.

Effective Date

The provision would be effective with respect to losses on sales or exchanges of old residences after the date of enactment, for determining recognized gain on principal residences sold or exchanged after December 31, 1993.

D. Prohibition of State "source tax" on periodic pension distributions

Present Law

Under present law, States are not prohibited under Federal law from imposing income tax on the pension income earned within the State but paid to an individual who is no longer a resident of the State.

Description of Proposal

The proposal would prohibit a State from imposing income tax on certain periodic pension distributions made to any individual who is not a resident or domiciliary of the State. A distribution would be exempt from State income taxation if it is a payment from a qualified plan that is part of series of substantially equal periodic payments (not less frequently than annually) made (1) for the life or life expectancy of the recipient and his or her beneficiary, or (2) over a specified period of 10 years or more. In addition, an individual who has attained age 59-1/2 could make a one-time election to exempt distributions totalling no more than $25,000 (indexed) in a taxable year.

For purposes of the proposal, a qualified plan includes (1) a qualified employees' trust (sec. 401(a)), (2) a simplified employee pension (SEP) (sec. 408(k)), (3) a qualified annuity plan (sec. 403(a)), (4) a tax-deferred annuity contract (sec. 403(b)), and (5) an individual retirement arrangement (IRA) (sec. 408).

Effective Date

The proposal would apply to taxable years beginning after December 31, 1991.

E. Employer Tax Credit for FICA Paid on Tip Income

Present Law

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

Organizations that provide food for the needy typically provide "food bags" to needy volunteers. This practice attracts additional volunteers, but is also a method of providing direct assistance to individuals who would otherwise qualify for aid. In response to questions raised by food bank operators as to whether the food bag practice could involve federal employment tax liabilities, the Treasury Department has stated that no employment tax obligations arise from the food banks' practice of providing food bags to needy volunteers. The food bags are not in the nature of compensation, but rather are given to volunteers who would otherwise qualify for aid.

Description of Proposal

The proposal would provide a business tax credit (sec. 38) in an amount equal to the employer's FICA tax obligation (7.65 percent) attributable to reported tips in excess of those treated as wages for purposes of satisfying the minimum wage provisions of the FLSA. To prevent double dipping, no deduction would be allowed for any amount taken into account in determining the credit. The proposal would prohibit carryback of unused FICA credits (sec. 39) to a taxable year ending before the date of enactment.

The proposal would clarify that the Treasury Department position that the provision by food banks of food bags to needy volunteers does not involve employment tax liabilities is in accord with Congressional intent and a correct interpretation of present law. The proposal would also clarify that the provision by food banks of food bags to needy volunteers does not impair the ability of donors to claim a charitable deduction for contributions to the food banks.

Effective Date

The proposal would be effective for tips received and wages paid after the date of enactment.

F. Tax exemption of veteran's benefits

Present Law

Present law provides that qualified military benefits are excludable from gross income. In general, a qualified military benefit is an allowance or in-kind benefit received by a member or former member of the uniformed services of the United States (or their spouses or dependents) and which was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice. In general, qualified benefits do not include modifications to benefits occurring after September 9, 1986.

The Treasury Department has recently stated that the provisions limiting the excludability of qualified military benefits applies to veterans' benefits. The Treasury Department has also indicated that forgiveness of mortgage indebtedness of veterans', cost-of-living increases to veterans' disability benefits, and in-kind benefits excludable on September 9, 1986, including modifications of such in-kind benefits are excludable from gross income.

Description of Proposal

The proposal would provide that veterans' benefits administered by the Secretary of the Veterans' Administration are excludable from gross income.

Effective Date

The proposal would be effective as if included in the provision of the Tax Reform Act of 1986 to which it relates.

G. Election not to apply 90-percent limitation on alternative minimum tax foreign tax credit

Present Law

Under present law, taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI[1] and (2) the denominator of that fraction is total AMTI.

The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit generally is limited to 90 percent of AMT computed without an AMT net operating loss deduction, an AMT energy preference deduction, or an AMT foreign tax credit. Certain domestic corporations operating solely in one foreign country with which the United States has an income tax treaty in effect are not subject to the 90-percent limitation on the use of the AMT foreign tax credit if certain other specified criteria are satisfied (sec. 59(a)(2)(C)). Any unused AMT foreign tax credit may be carried back two years and carried forward five years for use against AMT in those years under the principles of the foreign tax credit carryback and carryforward set forth in section 904(c).

Description of Proposal

Under the proposal, a domestic corporation would be permitted to elect to (1) forego the benefits of deferral of the income of all controlled foreign corporations of which it is a U.S. shareholder, and (2) be exempt from the 90-percent limitation on the utilization of the AMT foreign tax credit.

The election would be made by the common parent of a controlled group of corporations, using 50-percent ownership of the vote or value of stock as the standard of common control, and would apply to all domestic corporations included in that group.

The benefits of deferral would be foregone generally by treating all of a controlled foreign corporation's earnings

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[1] This is modified by the simplification provisions of the Chairman's Mark.

and profits for the taxable year as subpart F income, for purposes of determining the amount of subpart F income to be included in the income of the domestic corporation pursuant to section 951.

Amounts of subpart F income included in the gross income of the U.S. shareholder would be reduced by the shareholder's pro rata share of any deficits in earnings and profits in prior years beginning after December 31, 1992, for which the foreign corporation was a controlled foreign corporation.

The election under the proposal would be available only in the first taxable year beginning after December 31, 1992, for which the taxpayer claims an AMT foreign tax credit. A taxpayer would be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit, and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election would apply to all subsequent taxable years, and may be revoked only with the permission of the Secretary of the Treasury.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1992.

H. Pass-through treatment for certain dividends paid by a regulated investment company to foreign persons

Present Law

Regulated investment companies

A regulated investment company ("RIC") is treated as a conduit for Federal income tax purposes. Conduit treatment is accomplished by permitting a RIC to deduct dividends paid to its shareholders in computing its taxable income. To qualify as a RIC, a corporation must satisfy certain tests. These tests include a requirement that the corporation derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investment in such stock, securities, or currencies.

A RIC generally may designate a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain (i.e., net long-term capital gain over net short-term capital loss). These capital gain dividends are treated as long-term capital gain by the shareholders. A RIC generally also can pass through to its shareholders tax-exempt interest from state and municipal bonds (as long as, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations). In this case, the RIC generally may designate a dividend it pays as an exempt-interest dividend to the extent that the RIC has tax-exempt interest income. These exempt-interest dividends are treated as interest excludable from gross income by the shareholders.

U.S. source investment income of foreign persons

Under the Code, the United States generally imposes a flat 30-percent withholding tax on the gross amount of U.S. source investment income payments, such as income and dividends, to foreign persons. Under treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, however, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment dividends received by foreign persons generally are subject to at least a 15-percent U.S. withholding tax.

There is no 30-percent U.S. tax with respect to portfolio interest paid on certain indebtedness by U.S. borrowers to nonresident alien individuals and foreign corporations. In addition, under the Code, foreign persons are generally not subject to U.S. tax on gain realized on the

disposition of stock or securities issued by a U.S. person (other than a U.S. real property holding corporation), unless the gain is effectively connected with the conduct of a trade or business in the United States. Foreign persons receiving capital gain dividends from U.S. RICs have been treated as receiving capital gains not subject to U.S. tax, rather than dividends subject to the ordinary U.S. withholding tax on dividends.

Description of Proposal

Under the proposal, a RIC that earns interest income which would not be subject to U.S. tax if earned by a foreign person may, to the extent of such income, designate a dividend it pays as deriving from such interest income. A foreign person who is a shareholder in the RIC generally would treat such a dividend as if the foreign person had earned the interest directly. Similarly, a RIC that earns an excess of net short-term capital gains over net long-term capital losses, which excess would not be subject to U.S. tax if earned by a foreign person, may, to the extent of such excess, designate a dividend it pays as deriving from such excess. A foreign person who is a shareholder in the RIC generally would treat such a dividend as if the foreign person had realized the excess directly.

Effective Date

The proposal is effective with respect to taxable years of regulated investment companies beginning after date of enactment.

I. Study of recovery period for the depreciation of semi-conductor manufacturing equipment

Present Law

Equipment used in the manufacture of semi-conductors is treated as 5-year property under the accelerated cost recovery system as modified by the Tax Reform Act of 1986. Consequently, the depreciation deductions for semi-conductor manufacturing equipment are determined by using a 5-year recovery period, the applicable convention, and the 200-percent declining balance method switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

The Department of Treasury is required to monitor and analyze the actual experience of taxpayers with respect to depreciable assets and to report the findings to Congress.

Description of Proposal

The Department of Treasury would be required to study the appropriate recovery period and class life under section 168 of the Code for semi-conductor manufacturing equipment. The results of the study would be submitted to the House Committee on Ways and Means and the Senate Committee on Finance before April 1, 1993.

Effective Date

The proposal would be effective on the date of enactment.

J. Treasury study on competitiveness

Present Law

The United States imposes taxes that affect economic behavior, as do other countries.

Description of Proposal

Under the proposal, the Secretary of the Treasury is to conduct a study of tax issues relating to the maintenance and enhancement of the competitiveness of the American economy in light of changing economic policies in Europe and the increasing globalization of the world economy.

Effective Date

The proposal would require a Treasury report on the study by January 1, 1994. The report would be submitted to the Senate Committee on Finance and the House Committee on Ways and Means.

K. Permit a common trust fund to convert into a regulated investment company and a regulated investment company to convert to a common trust fund without taxation

Present Law

A common trust fund is a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, guardian, or custodian of certain accounts and in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks (sec. 584(a)).

The common trust fund of a bank is not subject to tax and is not treated as a corporation (sec. 584(b)). Each participant in a common trust fund includes his proportional share of common trust fund income, whether or not the income is distributed or distributable (sec. 584(c)).

No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of such interest. Withdrawals from the fund generally are treated as the sale of such interest by the participant (sec. 584(e)).

A regulated investment company (RIC) also is treated as a conduit for Federal income tax purposes. Present law is unclear as to the tax consequences when a common trust fund transfers its assets, or converts its status, to a RIC. There is a tax when a RIC transfers its assets, or converts its status, to a common trust fund.

Description of Proposal

In general, the proposal permits a common trust fund to transfer substantially all of its assets to a RIC without gain or loss being recognized by the fund or its participants. The fund must transfer its assets to the RIC solely in exchange for shares of the RIC, 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 determining whether a transfer is solely in exchange for shares of the RIC, the assumption of liabilities by the RIC is to be ignored. A special rule, however, requires gain to be recognized to the extent the assumed liabilities exceed the aggregate adjusted bases (in the hands of the common trust fund) of the assets transferred to the RIC.

The basis of any asset that is received by the RIC will be the basis of the asset in the hands of the fund prior to transfer. In addition, the basis of any RIC shares that are

received by a fund participant will be the participant's basis in the interests exchanged. If the interests exchanged have different bases, then the RIC shares received by the participant will have different bases.

The tax-free transfer is not available to a common trust fund with assets that are not diversified. This rule assures that a fund participant will not change the nature of his investment without recognizing gain.

Similar rules are provided to permit a RIC to transfer its assets, or convert its status, to a common trust fund.

Under the proposal, a common trust fund that transfers its assets (or converts) to a RIC cannot subsequently transfer its assets (or convert) back to a common trust fund. Similarly, a RIC that transfers its assets (or converts) to a common trust fund cannot subsequently transfer its assets (or convert) back to a RIC.

No inference is intended as to the tax consequences under present law when a common trust fund transfers its assets, or converts its status, to a RIC.

Effective Date

The proposal is effective for transfers after the date of enactment.

X. ADDITIONAL REVENUE SOURCES

A. Administration Proposals

1. Mark-to-Market Accounting Method for Dealers in Securities

Present Law

A taxpayer that is a dealer in securities is required for Federal income tax purposes to maintain an inventory of securities held for sale to customers. A dealer in securities is allowed for Federal income tax purposes to determine (or value) the inventory of securities held for sale based on: (1) the cost of the securities; (2) the lower of the cost or market value of the securities; or (3) the market value of the securities.

If the inventory of securities is determined based on cost, unrealized gains and losses with respect to the securities are not taken into account for Federal income tax purposes. If the inventory of securities is determined based on the lower of cost or market value, unrealized losses (but not unrealized gains) with respect to the securities are taken into account for Federal income tax purposes. If the inventory of securities is determined based on market value, both unrealized gains and losses with respect to the securities are taken into account for Federal income tax purposes.

For financial accounting purposes, the inventory of securities generally is determined based on market value.

Description of Proposal

In general

The proposal would provide two general rules (the "mark-to-market rules") that apply to certain securities that are held by a dealer in securities. First, any such security that is inventory in the hands of the dealer would be required to be included in inventory at its fair market value. Second, any such security that is not inventory in the hands of the dealer and that is held as of the close of any taxable year would be treated as sold by the dealer for its fair market value on the last business day of the taxable year and any gain or loss would be required to be taken into account by the dealer in determining gross income for that taxable year.[1]

(Footnote continued)

If gain or loss is taken into account with respect to a security by reason of the second mark-to-market rule, then the amount of gain or loss subsequently realized as a result of a sale, exchange, or other disposition of the security, or as a result of the application of the mark-to-market rules, would be appropriately adjusted to reflect such gain or loss. In addition, the proposal would authorize the Treasury Department to promulgate regulations that provide for the application of the second mark-to-market rule at times other than the close of a taxable year or the last business day of a taxable year.

Character of gain or loss

Any gain or loss taken into account under the proposal (or any gain or loss recognized with respect to a security that would be subject to the proposal) generally would be treated as ordinary gain or loss. This special character rule would not apply to any security that is a hedge of a security that is not subject to a mark-to-market rule or of a position, right to income, or a liability that is not a security in the hands of the taxpayer. Anti-abuse rules would be adopted to prevent straddle opportunities.

Definitions

A dealer in securities would be defined as any taxpayer that either (1) regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.

A security would be defined as: (1) any share of stock in a corporation; (2) any partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (3) any note, bond, debenture, or other evidence of

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[1] (continued)

[1] For purposes of the proposal, a security would be treated as sold to a person that is not related to the dealer even if the security is a contract between the dealer and a related person. Thus, for example, sections 267 and 707(b) of the Code would not apply to any loss that would be required to be taken into account under the proposal.

In addition, a security subject to the proposal would not be treated as sold and reacquired for purposes of section 1091 of the Code. Section 1092 of the Code would apply to any loss recognized by the mark-to market rules, unless all offsetting positions making up the straddle are subject to the mark-to market rules.

indebtedness; (4) any interest rate, currency, or equity notional principal contract (but not any other notional principal contract such as a notional principal contract that is based on the price of oil, wheat, or other commodity); and (5) any evidence of an interest in, or any derivative financial instrument in, a security described in (1) through (4) above or any currency, including any option, forward contract, short position, or any similar financial instrument in such a security or currency.

In addition, a security would be defined to include any position if: (1) the position is not a security described in the preceding paragraph; (2) the position is a hedge with respect to a security described in the preceding paragraph; and (3) before the close of the day on which the position was acquired or entered into (or such other time as the Treasury Department may specify in regulations), the position is clearly identified in the dealer's records as a hedge with respect to a security described in the preceding paragraph. A security, however, generally would not include a contract to which section 1256(a) of the Code applies, unless such contract is a hedge of a security to which the proposal would apply.

Exceptions to the mark-to-market rules

Notwithstanding the definition of security, the mark-to-market rules generally do not apply to: (1) any security that is held for investment; (2) any evidence of indebtedness that is acquired (including originated) by a dealer in the ordinary course of a trade or business of the dealer but only if the evidence of indebtedness is not held for sale; (3) any security that is acquired by a floor specialist of a national securities exchange or a market maker of the National Association of Security Dealers Automated Quotation System, in connection with the specialist's or market maker's duties as a specialist or market maker; (4) any security which is a hedge with respect to a security that is not subject to the mark-to-market rules (i.e., any security that is a hedge with respect to (a) a security held for investment, (b) an evidence of indebtedness described in (2)), or (c) a security of a floor specialist described in (3)); and (5) any security which is a hedge with respect to a position, right to income, or a liability that is not a security in the hands of the taxpayer.

In addition, the exceptions to the mark-to-market rules would not apply unless the security is clearly identified in the dealer's records as being described in one of the exceptions listed above. Finally, a dealer would be required to continue to hold the security in a capacity that qualifies the security for one of the exceptions listed above.

Other rules

The uniform cost capitalization rules of section 263A of the Code and the rules of section 263(g) of the Code that require the capitalization of certain interest and carrying charges in the case of straddles would not apply to any security to which the mark-to-market rules apply.

In addition, the Treasury Department would be authorized to promulgate such regulations as may be necessary or appropriate to carry out the proposal, including rules to prevent the use of year-end transfers, related persons, or other arrangements to avoid the proposal.

A similar proposal was included in H.R. 4210 as passed by the House and Senate and H.R. 3040 as amended by the Senate Finance Committee (with an additional exception for securities of certain market makers and rules providing for the treatment of the character of any gain or loss arising under the proposal).

Effective Date

The proposal would apply to taxable years ending on or after December 31, 1992. A taxpayer that would be required to change its method of accounting to comply with the requirements of the provision is treated as having initiated the change in method of accounting and as having received the consent of the Treasury Department to make such change.

The net amount of the section 481(a) adjustment would be taken into account ratably over a 10-taxable year period beginning with the first taxable year ending on or after December 31, 1992, to the extent that such amount does not exceed the net amount of the section 481(a) adjustment that would have been determined had the change in method of accounting occurred for the last taxable year beginning before March 20, 1992.

The excess (if any) of (1) the net amount of the section 481(a) adjustment for the first taxable year ending on or after December 31, 1992, over (2) the net amount of the section 481(a) adjustment that would have been determined had the change in method of accounting occurred for the last taxable year beginning before March 20, 1992, would be taken into account ratably over a 4-taxable year period beginning with the first taxable year ending on or after December 31, 1992.

The principles of section 8.03 of Rev. Proc. 92-20, 1992-12 I.R.B. 10, would apply to the section 481(a) adjustment. It is anticipated that section 8.03(1) of Rev. Proc. 92-20 would be applied by taking into account all securities of a dealer that are subject to the mark-to-market rules (including those securities that are not inventory in the hands of the dealer).

No addition to tax would apply to any underpayment of estimated tax that is due before the date of enactment of this proposal to the extent that the underpayment is attributable to the enactment of this proposal.

2. Modify Estimated Tax Requirements for Individuals

Present Law

Under present law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax liability of the prior year (the "100 percent of last year's liability safe harbor") or (2) 90 percent of the tax liability of the current year. Income tax withholding from wages is considered to be a payment of estimated taxes.

In addition, for taxable years beginning after 1991 and before 1997, the 100 percent of last year's liability safe harbor generally is not available to a taxpayer that (1) has an adjusted gross income (AGI) in the current year that exceeds the taxpayer's AGI in the prior year by more than $40,000 ($20,000 in the case of a separate return by a married individual) and (2) has an adjusted gross income (AGI) in excess of $75,000 in the current year ($37,500 in the case of a separate return by a married individual).

Description of Proposal

The special rule that denies the use of the 100 percent of last year's liability safe harbor would be repealed for taxable years beginning after 1992. In addition, the 100 percent of last year's liability safe harbor would be modified to be a 120 percent of last year's liability.

Thus, for taxable years beginning after 1992, any individual generally would not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 120 percent of the tax liability of the prior year or (2) 90 percent of the tax liability of the current year.

Effective Date

The proposal would be effective for estimated tax payments applicable to taxable years beginning after December 31, 1992.

3. Modify Estimated Tax Requirements for Corporations

Present Law

A corporation is subject to an addition to tax for any underpayment of estimated tax. For taxable years beginning after June 30, 1992 and before 1997, a corporation does not have an underpayment of estimated tax if it makes four equal timely estimated tax payments that total at least 97 percent of the tax liability shown on the return for the current taxable year. In addition, a corporation may annualize its taxable income and make estimated tax payments based on 97 percent of the tax liability attributable to such annualized income. For taxable years beginning after 1996, the 97-percent requirement becomes a 91-percent requirement. The prsent-law 97-percent and 91-percent requirements were added by the Unemployment Compensation Amendments of 1992.

A corporation that is not a "large corporation" generally may avoid the addition to tax if it makes four timely estimated tax payments each equal to at least 25 percent of the tax liability shown on its return for the preceding taxable year (the "100 percent of last year's liability safe harbor"). A large corporation may use this rule with respect to its estimated tax payment for the first quarter of its current taxable year. A large corporation is one that had taxable income of $1 million or more for any of the three preceding taxable years.

Description of Proposal

For taxable years beginning after 1992, a corporation would be required to base its estimated tax payments on 100 percent of its current year tax liability, whether such liability is determined on an actual or annualized basis.

The proposal would not change the present-law availability of the 100 percent of last year's liability safe harbor for large or small corporations.

Effective Date

The proposal would be effective for estimated tax payments applicable to taxable years beginning after December 31, 1992.

4. Expansion of 45-Day Interest-Free Period for Certain Refunds

Present Law

No interest is paid by the Government on a refund arising from an income tax return if the refund is issued by the 45th day after the later of the due date for the return (determined without regard to any extensions) or the date the return is filed (sec. 6611(e)).

There is no parallel rule for refunds of taxes other than income taxes (i.e., employment, excise, and estate and gift taxes), for refunds of any type of tax arising from amended returns, or for claims for refunds of any type of tax.

If a taxpayer files a timely original return with respect to any type of tax and later files an amended return claiming a refund, and if the IRS determines that the taxpayer is due a refund on the basis of the amended return, the IRS will pay the refund with interest computed from the due date of the original return.

Description of Proposal

Under the proposal, no interest would be paid by the Government on a refund arising from any type of original tax return if the refund is issued by the 45th day after the later of the due date for the return (determined without regard to any extensions) or the date the return is filed.

A parallel rule would apply to amended returns and claims for refunds: if the refund is issued by the 45th day after the date the amended return or claim for refund is filed, no interest would be paid by the Government for that period of up to 45 days (interest would continue to be paid for the period from the due date of the return to the date the amended return or claim for refund is filed). If the IRS does not issue the refund by the 45th day after the date the amended return or claim for refund is filed, interest would be paid (as under present law) for the period from the due date of the original return to the date the IRS pays the refund.

A parallel rule also would apply to IRS-initiated adjustments (whether due to computational adjustments or audit adjustments). With respect to these adjustments, the IRS would pay interest for 45 fewer days than it otherwise would.

Effective Date

The extension of the 45-day processing rule would be effective for returns required to be filed (without regard to extensions) on or after October 1, 1992. The amended return rule would be effective for returns and claims for refunds filed on or after October 1, 1992 (regardless of the taxable period to which they relate). The rule relating to IRS-initiated adjustments would be applicable to refunds paid on or after October 1, 1992 (regardless of the taxable period to which they relate).

5. Tax treatment of certain FSLIC financial assistance

Present Law and Background

A taxpayer may claim a deduction for a loss on the sale or other disposition of property only to the extent that the taxpayer's adjusted basis for the property exceeds the amount realized on the disposition and the loss is not compensated for by insurance or otherwise (sec. 165 of the Code). A similar rule applies for purposes of accounting for bad debts.

A special statutory tax rule, enacted in 1981, excluded from a thrift institution's income financial assistance received from the Federal Savings and Loan Insurance Corporation (FSLIC), and prohibited a reduction in the tax basis of the thrift institution's assets on account of the receipt of the assistance. Under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), taxpayers generally were required to reduce certain tax attributes by one-half the amount of financial assistance received from the FSLIC pursuant to certain acquisitions of financially troubled thrift institutions occurring after December 31, 1988. These special rules were repealed by FIRREA, but still apply to transactions that occurred before May 10, 1989.

Prior to the enactment of FIRREA, the FSLIC entered into a number of assistance agreements in which it agreed to provide loss protection to acquirers of troubled thrift institutions by compensating them for the difference between the book value and sales proceeds of "covered assets."

A March 4, 1991 Treasury Department report ("Treasury report") on tax issues relating to the 1988/89 FSLIC transactions concluded that deductions should not be allowed for losses that are reimbursed with exempt FSLIC assistance. The Treasury report states that the Treasury view is expected to be challenged in the courts and recommended that Congress enact clarifying legislation disallowing these deductions.[1]

Description of Proposal

General rule

Any FSLIC assistance with respect to any loss of principal, capital, or similar amount upon the disposition of an asset would be taken into account as compensation for such loss for purposes of section 165 of the Code. Any FSLIC

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[1] Department of the Treasury, Report on Tax Issues Relating to the 1988/89 Federal Savings and Loan Insurance Corporation Assisted Transactions, March, 1991 at pp. 16-17.

assistance with respect to any debt would be taken into account for purposes of determining whether such debt is worthless (or the extent to which such debt is worthless) and in determining the amount of any addition to a reserve for bad debts.

Financial assistance to which the FIRREA amendments apply

The proposal would not apply to any financial assistance to which the amendments made by section 1401(a)(3) of FIRREA apply.

No inference

No inference would be intended as to prior law or as to the treatment of any item to which this proposal does not apply.

Effective Date

In general

The proposal would apply to financial assistance credited on or after March 4, 1991, with respect to (1) assets disposed of and charge-offs made in taxable years ending on or after March 4, 1991; and (2) assets disposed of and charge-offs made in taxable years ending before March 4, 1991, but only for purposes of determining the amount of any net operating loss carryover to a taxable year ending on or after March 4, 1991.

For this purpose, financial assistance would be considered to be credited when the taxpayer makes an approved debit entry to a Special Reserve Account required to be maintained under the assistance agreement to reflect the asset disposition or write-down. An amount would also be considered to be credited prior to March 4, 1991, if the asset was sold, with prior FSLIC approval, before that date.

Application to certain net operating losses

The proposal would apply to the determination of any net operating loss carried into a taxable year ending on or after March 4, 1991, to the extent that the net operating loss is attributable to a loss or charge-off for which the taxpayer had a right to FSLIC assistance which had not been credited before March 4, 1991.

Estimated tax payments

Finally, the proposal would waive additions to tax for underpayments relating to certain estimated tax payments.

6. Reporting of amounts of property tax reimbursements paid to sellers of residences

Present Law

Individual taxpayers who itemize deductions may deduct State and local real property taxes. Under Code section 164(d)(1), if real property is sold during any real property tax year, the part of the real property tax that is properly allocable to that part of the year that ends on the day before the date of sale is treated as imposed on the seller. The part of the real property tax that is properly allocable to that part of the year that begins on the date of sale is treated as imposed on the buyer.

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

Description of Proposal

The proposal would provide that in the case of a real estate transaction involving a residence, the real estate reporting person would be required to include on an information return and on the customer statements the portion of any real property tax that is treated as a tax imposed on the purchaser.

Effective Date

The provision would be effective for transactions after December 31, 1992.

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

Present Law

Gross income for purposes of the Internal Revenue Code generally includes all income from whatever source derived, including rents. The Code (sec. 280A(g)) provides a *de minimis* exception to this rule where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year. In this case, the income from such rental is not included in gross income and no deductions arising from such rental use are allowed as a deduction.

Description of Proposal

The proposal would repeal section 280A(g) and, therefore, would require taxpayers to include in income the rental income received with respect to the rental of a residence without regard to the period of the rental. The rules of section 280A(c)(3) and (e) would govern the deductibility of expenses attributable to the rental of such property.

Effective Date

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

B. Extension of Existing Provisions

1. Five-Year Extension of Top Estate and Gift Tax Rates

Present Law

The Federal estate and gift taxes are unified so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The generation-skipping transfer tax is computed by reference to the maximum Federal estate tax rate.

For 1992, the Federal estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent on taxable transfers in excess of $3 million. For transfers occurring after 1992, the maximum Federal estate and gift tax rates are scheduled to decline to 50 percent on taxable transfers over $2.5 million.

In addition, the benefit of the graduated rates and the unified credit is phased-out for at a 5-percent rate for taxable transfers in excess of $10,000,000 and $21,040,000.

Description of Proposal

The proposal would defer for five years the estate and gift tax rate reductions that were scheduled to take effect after 1992 until after 1997. Also, the rate of tax on generation skipping transfers would remain at 55 percent until after 1997.

2. Extension of Personal Exemption Phaseout

Present Law

Present law permits a personal exemption deduction from gross income for an individual, the individual's spouse, and each dependent. For 1992, the amount of this deduction is $2,300 for each exemption claimed. This exemption amount is adjusted for inflation. The deduction for personal exemptions is phased out for taxpayers with adjusted gross income (AGI) above a threshold amount (indexed for inflation) which is based on filing status. For 1992, the threshold amounts are $157,900 for married taxpayers filing joint returns, $78,950 for married taxpayers filing separate returns, $131,550 for unmarried taxpayers filing as head of household, and $105,250 for unmarried taxpayers filing as single.

The total amount of exemptions which may be claimed by a taxpayer is reduced by 2 percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold (the phaseout rate is 4 percent for married taxpayers filing separate returns). Thus, the personal exemptions claimed are phased out over a $122,500 range, beginning at the applicable threshold.

This provision does not apply to taxable years beginning after December 31, 1996.

Description of Proposal

The proposal would extend permanently the present-law personal exemption phaseout applicable to higher-income taxpayers.

Effective Date

The proposal would be effective for taxable years beginning in or after 1997.

3. Extension of Itemized Deduction Limitation

Present Law

Under present law, individuals who do not elect the standard deduction may claim itemized deductions (subject to certain limitations) for certain nonbusiness expenses incurred during the taxable year. Among these deductible expenses are unreimbursed medical expenses, casualty and theft losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Certain itemized deductions are allowed only to the extent that the amount exceeds a specified percentage of the taxpayer's adjusted gross income (AGI). Unreimbursed medical expenses for care of the taxpayer and the taxpayer's spouse and dependents are deductible only to the extent that the total of these expenses exceeds 7.5 percent of the taxpayer's AGI. Nonbusiness casualty or theft losses are deductible only to the extent that the amount of loss arising from each casualty or theft exceeds $100 and only to the extent that the net amount of casualty and theft losses exceeds 10 percent of the taxpayer's AGI. Unreimbursed employee business expenses and certain other miscellaneous expenses are deductible only to the extent that the total of these expenses exceeds 2 percent of the taxpayer's AGI.

The total amount of otherwise allowable itemized deductions (other than medical expenses, casualty and theft losses, and investment interest) is reduced by 3 percent of the amount of the taxpayer's AGI in excess of $105,250 in 1992 (indexed for inflation). Under this provision, otherwise allowable itemized deductions may not be reduced by more than 80 percent. In computing the reduction of total itemized deductions, all present-law limitations applicable to such deductions are first applied and then the otherwise allowable total amount of deductions is reduced in accordance with this provision.

The reduction of otherwise allowable itemized deductions does not apply to taxable years beginning after December 31, 1995.

Description of Proposal

The proposal would extend permanently the present-law itemized deduction limitation applicable to higher-income individuals.

Effective Date

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

C. Other Revenue-Increase Provisions

1. Treatment of Pre-Contribution Gain on Certain Partnership Redemptions

Present Law

Generally, if a partner contributes appreciated property to a partnership, no gain is recognized to the contributing partner at the time of the contribution, and the contributing partner's basis in his partnership interest is increased by the basis of the contributed property at the time of the contribution. The pre-contribution gain is reflected in the difference between the partner's capital account and his basis in his partnership interest ("book/tax differential"). Gain recognized subsequently by the partnership with respect to that property must be allocated to the contributing partner to the extent of the remaining book/tax differential. In addition, if the property is subsequently distributed to another partner within 5 years of the contribution, the contributing partner generally will recognize gain as if the property had been sold for its fair market value at the time of the distribution.

Present law generally does not require a partner who contributes appreciated property to a partnership to recognize pre-contribution gain upon a subsequent distribution of other property to that partner even if the value of that other property exceeds the partner's basis in his partnership interest.

Description of Proposal

The proposal would require a partner who contributes appreciated property to a partnership to include pre-contribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds his adjusted basis in his partnership interest The proposal applies whether or not the contributing partner's interest in the partnership is reduced in connection with the distribution. Because of the 5-year limitation of present law, the provision can apply only if the distribution is made within 5 years after the contribution of the appreciated property. Appropriate basis adjustments are to be made in the basis of the distributee partner's interest in the partnership and the partnership's basis in the contributed property to take account of gain recognized by the distributee partner.

Gain recognition generally is not required to the extent the partnership distributes property which had been contributed by the distributee partner. If the property distributed consists of an interest in an entity, however, gain recognition is nevertheless required to the extent that

the value of the interest in the entity is attributable to property contributed to the entity after the interest in it was contributed to the partnership. Similarly, the proposal provides that if contributed property is distributed indirectly to a partner other than its contributor, the contributing partner is subject to tax on the pre-contribution gain as if the property had been distributed directly rather than indirectly.

Effective Date

The proposal would apply to partnership distributions on or after June 25, 1992.

2. Taxable Year Election for Partnerships, S Corporations, and Personal Service Corporations

Present Law

A partnership is generally required for Federal income tax purposes to use the taxable year that is used by a majority of its partners. An S corporation is generally required for Federal income tax purposes to use the calendar year as its taxable year. A personal service corporation also is generally required for Federal income tax purposes to use the calendar year as its taxable year.[1]

A partnership, S corporation, or personal service corporation, however, may elect to use a taxable year other than the required taxable year. In the case of a partnership, S corporation, or personal service corporation that is adopting a taxable year or changing a taxable year, the taxable year that may be elected generally may not result in a deferral period of more than three months. For this purpose, the deferral period generally is the number of months between (1) the beginning of the taxable year of the partnership, S corporation, or personal service corporation, and (2) the close of the first required taxable year that ends within such year.

A partnership or S corporation that elects a taxable year other than the required taxable year is required to make a payment to the Internal Revenue Service (a "required payment") that is designed to compensate the Federal government for the deferral of tax that results from the use of a taxable year other than the required taxable year. A personal service corporation that elects a taxable year other than the required taxable year is required to satisfy a minimum distribution requirement that applies to certain amounts paid by the personal service corporation to employee-owners.

Description of Proposal

A partnership, S corporation, or personal service corporation would be allowed to elect any taxable year without regard to the length of the deferral period of the taxable year elected if the annual financial statements (if any) of the entity used for credit purposes or provided to

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[1] For this purpose, a personal service corporation is defined as a C corporation the principal activity of which is the performance of services if (1) the services are substantially performed by employee-owners, and (2) more than 10 percent of the stock of the corporation is owned by employee-owners.

the partners, shareholders, or other proprietors of the entity cover the same period as the taxable year elected.

The proposal would increase the amount of the required payment that must be made by a partnership or S corporation that elects a taxable year other than the required taxable year (including any partnership or S corporation that has an election in effect on the date of enactment of the proposal).[2] In addition, the proposal would require an additional required payment for any taxable year that a partnership or S corporation first makes a taxable year election or changes a taxable year election to increase the deferral period.

The proposal would also increase the minimum distribution requirement that must be satisfied by a personal service corporation that elects a taxable year other than the required taxable year (including a personal service corporation that has an election in effect on the date of enactment of the proposal).

The proposal is the same as was included in H.R. 4210 as passed by the House and Senate (except that the proposal included in H.R. 4210 applied to taxable years beginning after December 31, 1991).

Effective Date

The proposal would apply to taxable years beginning after December 31, 1992.

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2 The required payment would be determined by using the highest rate of tax in effect under section 1 of the Code plus 2 percentage points.

3. Deduction for moving expenses

Present Law

An employee or self-employed individual may deduct from gross income certain expenses incurred as a result of moving to a new residence in connection with beginning work at a new location (sec. 217). The deduction is not subject to the floor that generally limits a taxpayer's allowable miscellaneous itemized deductions to those amounts that exceed 2 percent of his or her adjusted gross income. Any amount received directly or indirectly by such individual as a reimbursement of moving expenses must be included in the taxpayer's gross income as compensation (sec. 82), but a deduction is permitted for the amount that would otherwise qualify as deductible moving expenses under sec. 217.

Deductible moving expenses are the expenses of transporting the taxpayer and members of his household, their household goods, and their personal effects from the old to the new residence; the cost of meals and lodging en route; the expense for pre-move househunting trips; temporary living expenses for up to 30 days (90 days in the case of foreign moves)[1] in the general location of the new job; and certain expenses related to both the sale of or settlement of a lease on the old residence and the purchase of a new residence in the general location of the new job.

The moving expense deduction is subject to a number of limitations. A maximum of $1,500 can be deducted for pre-move househunting and temporary living expenses in the general location of the new job. A maximum of $3,000 (reduced by any deduction claimed for househunting or temporary living expenses) can be deducted for certain qualified expenses for the sale and purchase of a residence or settlement of a lease. For foreign moves, the above limits are $4,500 and $6,000 respectively. If both a husband and wife begin new jobs in the same general location, the move is treated as a single commencement of work. If a husband and wife file separate returns, the maximum deduction available to each is one-half the amounts otherwise allowed.

Also, in order for a taxpayer to claim a moving expense deduction, his new principal place of work has to be at least 35 miles farther from his former residence than was his former principal place of work (or his former residence, if he has no former place of work).

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1 Section 217(h)(3) defines a foreign move as the commencement of work by the taxpayer at a new principal place of work located outside the United States.

Description of Proposal

The proposal would deny the moving expense deduction for qualified expenses for the sale and purchase of a residence or settlement of a lease and would also deny the moving expense deduction for all meal and entertainment expenses.

Effective Date

The proposal is effective for taxable years beginning after December 31, 1992.

4. Information reporting on State and local tax payments and refunds

Present Law

Individual taxpayers who itemize deductions may deduct State and local income, real property, and personal property taxes. The refund, credit, or offset of such State or local taxes that were deducted (with a resulting tax benefit) in a previous year is includible in the taxpayer's gross income. There is no provision of present law that requires State and local governments to provide information reports to the IRS and the taxpayer on payments of State and local real property taxes or on refunds, credits, or offsets of such taxes.

Description of Proposal

The proposal would require any State or local government that imposes a real property tax to report to the individual who paid those taxes and to the IRS the amount of those taxes paid by the individual. These information reports would set forth the amount of payments, credits, or offsets and the name, address, and taxpayer identification number of the individual paying such tax or receiving such payment, credit, or offset. In the case of payments made on behalf of the taxpayer by another entity, such as a mortgagor, that entity would provide the information to the taxpayer and the IRS.

The information reports would be filed in accordance with the timetable generally applicable to other information returns. Consequently, the copy for the taxpayer would be provided by the last day of January of the year following the year these taxes are paid; the State and local government would have one additional month (until the end of February) to supply the information return to the IRS.

In order to reduce the burden on the State and local governments, the proposal would provide that no information return need be provided to the individual taxpayer if it were determined that that individual taxpayer does not itemize deductions.

Effective Date

The provision would be effective for payments made after December 31, 1993. Thus, State and local governments will first provide information returns to individual taxpayers by the end of January 1995, and to the IRS by the end of February 1995, on taxes that were paid in 1994.

5. **Withholding on supplemental wage payments**

Present Law

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

Description of Proposal

The withholding rate on supplemental wage payments would be increased from 20 percent to 28 percent.

Effective Date

The provision is effective for payments of supplemental wages made after December 31, 1992.

6. Increase withholding on gambling winnings

Present Law

In general, proceeds from a wagering transaction are subject to withholding at a rate of 20% if such proceeds exceed $1,000 and if the amount of such proceeds is at least 300 times as large as the amount wagered. The proceeds from a wagering transaction are determined by subtracting from the amount received the amount wagered. Any non-monetary proceeds that are received are taken into account at fair market value.

In the case of State-conducted lotteries, proceeds from a wager are subject to withholding at a rate of 20% if such proceeds exceed $5,000, regardless of the odds of the wager. This rule applies only if the wager is placed with the State agency conducting the lottery or with its authorized agents or employees.

In the case of sweepstakes, wagering pools, or lotteries other than State-conducted lotteries, proceeds from a wager are subject to withholding at a rate of 20% if such proceeds exceed $1,000, regardless of the odds of the wager.

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

Description of Proposal

The rate of withholding on proceeds from a wagering transaction would be increased to 28%.

Effective Date

The provision would be effective for wagering transactions after December 31, 1992.

XI. TECHNICAL CORRECTIONS
(S.750, with Modifications)

Technical Corrections to the Revenue Reconciliation Act of 1990

A. Individual Income Tax Provisions

1. Minimum tax rate on certain nonresident aliens (sec. 11102 of the 1990 Act and sec. 897 of the Code)

Present Law

The Revenue Reconciliation Act of 1990 (the "1990 Act") increased the alternative minimum tax rate on individuals from 21 percent to 24 percent.

Description of Proposal

The proposal would conform the rate of the minimum tax on the U.S. real property gains of nonresident aliens to the 24 percent minimum tax rate enacted in the 1990 Act.

2. Tax rate of personal holding companies (sec. 11101 of the 1990 Act and sec. 541 of the Code)

Present Law

A corporation that is treated as a personal holding company is subject, in addition to the regular corporate tax, to a 28-percent tax on its undistributed personal holding company income for the taxable year. The present-law rate of 28 percent was set by the Tax Reform Act of 1986.[1] This rate reflected the maximum rate of tax on individuals in that Act.

The 1990 Act increased the maximum rate of tax on individuals from 28 percent to 31 percent effective for taxable years beginning after December 31, 1990.

Description of Proposal

The proposal would provide that the increase in the individual maximum tax rate to 31 percent also applies to the personal holding company tax rate, effective for taxable years beginning after December 31, 1990.

3. Definition of AGI for the earned income tax credit and the supplemental earned income tax credit for health insurance premiums (sec. 11111 of the 1990 Act and sec. 32 of the Code)

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[1] See P.L. 99-514, sec. 104 (b)(8).

Present Law

Under present law, a supplemental earned income tax credit (EITC) is available to certain taxpayers for qualified health insurance expenses. Qualified health insurance expenses for which the credit is available are amounts paid during the taxable year for health insurance coverage that includes one or more qualifying children. These expenses include only those expenses relating to the cost of coverage (i.e., premium cost) paid with after-tax dollars. The maximum credit is $428 in 1991. The credit is phased out as adjusted gross income (AGI) (or earned income, if greater) exceeds $11,250 in 1991. Earned income amounts taken into account in computing the maximum credit and the beginning point of the phase-out range are indexed for inflation.

The calculation of this supplemental child health insurance credit is generally the same as the calculation of the basic EITC. Thus, the same eligibility criteria and income phase-in and phase-out requirements apply. There is no family size adjustment with respect to the health insurance credit.

Present law provides that the amount of expenses taken into account in determining the deduction for health insurance costs of self-employed individuals (sec. 162(l)) is reduced by the amount (if any) of the supplemental child health insurance credit allowable to the taxpayer (sec. 162(l)(3)(B)). This so-called "double-dip" provision creates a calculation problem because the amount of the EITC, the supplemental young child credit, and the child health insurance credit cannot be determined until AGI is determined; however, AGI is determined with reference to the deduction for health insurance costs of self-employed individuals. Thus, the operation of the double-dip provision creates a circularity that increases the complexity of the child health credit.

Description of Proposal

Under the proposal, for purposes of the EITC, the supplemental young child credit, and the supplemental child health insurance credit, AGI would be calculated assuming that the taxpayer is entitled to the full deduction for health insurance costs under section 162(l). Then, after the maximum child health credit is determined, the double-dip rule (sec. 162(l)(3)(B)) would operate as it does under present law.

B. Excise Tax Provisions

1. Application of the 2.5-cents-per-gallon tax on fuel used in rail transportation to States and local governments (sec. 11211(b)(4) of the 1990 Act and sec. 4093 of the Code)

Present Law

The 1990 Act increased the highway and motorboat fuels taxes by 5 cents per gallon, effective on December 1, 1990. The 1990 Act continued the exemption from these taxes for fuels used by States and local governments.

The 1990 Act also imposed a 2.5-cents-per-gallon tax on fuel used in rail transportation, also effective on December 1, 1990. Because of a drafting error in the 1990 Act, the 2.5-cents-per-gallon tax on fuel used in rail transportation incorrectly applies to States and local governments.

Description of Proposal

The proposal would clarify that the 2.5-cents-per-gallon tax on fuel used in rail transportation does not apply to such uses by States and local governments.

2. Deposit of certain aviation tax revenues in Airport and Airway Trust Fund (sec. 11213 of the 1990 Act and sec. 9502(e)(1) of the Code)

Present Law

The 1990 Act increased the aviation excise tax rates (except for the international air departure tax rate) by 25 percent, and extended those taxes for five years, effective December 1, 1990, through December 31, 1995. From December 1, 1990 through 1992, the statement of managers on the 1990 Act indicated that the revenues attributable to the increased portion of the aviation taxes were to be retained in the General Fund; these revenues will be deposited in the Airport and Airway Trust Fund for 1993 through 1995. The statute as enacted in the 1990 Act omitted this agreement with respect to the taxes other than those imposed on aviation fuels (i.e., the revenues attributable to the increase in the air passenger ticket tax and the air cargo tax).

Description of Proposal

The proposal would clarify that revenues from all aviation excise taxes attributable to the increased rates imposed by the 1990 Act on taxable events during periods before January 1, 1993, will be retained in the General Fund. The proposal would not affect revenues attributable to the tax rates imposed before enactment of the 1990 Act and extended by that Act.

3. Small winery production credit and bonding requirements (sec. 11201 of the 1990 Act and sec. 5041 of the Code)

Present Law

A 90-cents-per-gallon credit is allowed to wine producers who produce no more than 250,000 gallons of wine in a year. The credit may be claimed against the producers' excise or income taxes.

Wine producers must post a bond in amounts determined by reference to expected excise tax liability as a condition of legally operating.

Description of Proposal

The proposal would clarify that wine produced by eligible small wineries may be transferred without payment of tax to bonded warehouses that become liable for payment of the wine excise tax without losing credit eligibility. In such cases, the bonded warehouse would be eligible for the credit to the same extent as the producer otherwise would have been.

The proposal would further clarify that the Treasury Department has broad regulatory authority to prevent the benefit of the credit from accruing (directly or indirectly) to wineries producing in excess of 250,000 gallons in a calendar year. This authority would be extended to all circumstances in which wine production is increased with a purpose of securing indirect credit eligibility for wine produced by such large producers.

The proposal also would clarify that the Treasury Department may take the amount of credit expected to be claimed against a producer's wine excise tax liability into account in determining the amount of required bond.

4. Floor stocks refunds for certain cigarette taxes (11202 of the 1990 Act)

Present Law

A floor stocks tax, equal to the amount of the rate increase, is imposed when the rates of Federal excise taxes (other than retail taxes) are increased. The cigarette excise tax rates are scheduled to increase on January 1, 1993. Refunds of this tax, as with the underlying excise tax, are permitted in certain cases.

Description of Proposal

The proposal would clarify that the Treasury Department may make refunds of the cigarette floor stocks tax to be imposed on January 1, 1993, to manufacturers rather than to the persons that actually pay the tax, if the manufacturers demonstrate that the benefit of the refund accrues to the person actually paying the tax.

C. Other Revenue-Increase Provisions of the 1990 Act

1. Deposits of Railroad Retirement Tax Act taxes (sec. 11334 of the 1990 Act and sec. 6302(g) of the Code)

Present Law

Employers must deposit income taxes withheld from employees' wages and FICA taxes that are equal to or greater than $100,000 by the close of the next banking day. Under the Railroad Retirement Solvency Act of 1983, the deposit rules for withheld income taxes and FICA taxes automatically apply to Railroad Retirement Tax Act taxes (sec. 226 of P.L. 98-76).

Description of Proposal

The proposal would conform the Internal Revenue Code to the Railroad Retirement Solvency Act of 1983 by stating in the Code that these deposit rules for withheld income taxes and FICA taxes apply to Railroad Retirement Tax Act taxes.

2. Treatment of salvage and subrogation of property and casualty insurance companies (sec. 11305 of the 1990 Act)

Present Law

For taxable years beginning after December 31, 1989, property and casualty insurance companies are required to reduce the deduction allowed for losses incurred (both paid and unpaid) by estimated recoveries of salvage and subrogation attributable to such losses. In the case of any property and casualty insurance company that took into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990, 87 percent of the discounted amount of the estimated salvage and subrogation recoverable as of the close of the last taxable year beginning before January 1, 1990, is allowed as a deduction ratably over the first 4 taxable years beginning after December 31, 1989. This special deduction was enacted in order to provide such property and casualty insurance companies with substantially the same Federal income tax treatment as that provided to those property and casualty insurance companies that prior to the Revenue Reconciliation Act of 1990 did not take into account estimated salvage and subrogation recoverable in determining losses incurred.

Description of Proposal

The proposal would provide that the earnings and profits of any property and casualty insurance company that took into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year

beginning before January 1, 1990, is to be determined without regard to the special deduction that is allowed over the first 4 taxable years beginning after December 31, 1989. The special deduction would be taken into account, however, in determining earnings and profits for purposes of applying sections 56, 902, 952(c)(1) and 960 of the Internal Revenue Code of 1986. This proposal may be felt necessary in order to provide those property and casualty insurance companies that took into account estimated salvage and subrogation recoverable in determining losses incurred with substantially the same Federal income tax treatment as that provided to those property and casualty insurance companies that prior to the 1990 Act did not take into account estimated salvage and subrogation recoverable in determining losses incurred.

3. Information with respect to certain foreign-owned or foreign corporations: Suspension of the statute of limitations during certain judicial proceedings (secs. 11314 and 11315 of the 1990 Act and secs. 6038A and 6038C of the Code)

Present Law

Any domestic corporation that is 25-percent owned by one foreign person is subject to certain information reporting and recordkeeping requirements with respect to transactions carried out directly or indirectly with certain foreign persons treated as related to the domestic corporation ("reportable transactions") (sec. 6038A(a)). In addition, the Code provides procedures whereby an IRS examination request or summons with respect to reportable transactions can be served on foreign related persons through the domestic corporation (sec. 6038A(e)). Similar provisions apply to any foreign corporation engaged in a trade or business within the United States, with respect to information, records, examination requests, and summonses pertaining to the computation of its liability for tax in the United States (sec. 6038C). Certain noncompliance rules may be applied by the Internal Revenue Service in the case of the failure by a domestic corporation to comply with a summons pertaining to a reportable transaction (a "6038A summons") (sec. 6038A(e)), or the failure by a foreign corporation engaged in a U.S. trade or business to comply with a summons issued for purposes of determining the foreign corporation's liability for tax in the United States (a "6038C summons") (sec. 6038C(d)).

Any corporation that is subject to the provisions of section 6038A or 6038C has the right to petition a Federal district court to quash a 6038A or 6038C summons, or to review a determination by the IRS that the corporation did not substantially comply in a timely manner with the 6038A or 6038C summons (sec. 6038A(e)(4)(A) and (B); sec. 6038C(d)(4)). During the period that either such judicial

proceeding is pending (including appeals), and for up to 90 days thereafter, the statute of limitations is suspended with respect to any transaction (or item, in the case of a foreign corporation) to which the summons relates (secs. 6038A(e)(4)(D), 6038C(d)(4)).

The legislative history of the 1989 Act amendments to section 6038A states that the suspension of the statute of limitations applies to "the taxable year(s) at issue."[2] The legislative history of the 1990 Act, which added section 6038C to the Code, uses the same language.[3]

Description of Proposal

The proposal would modify the provisions in sections 6038A and 6038C that suspend the statute of limitations to clarify that the suspension applies to any taxable year the determination of the amount of tax imposed for which is affected by the transaction or item to which the summons relates.

Under the proposal, a transaction or item would affect the determination of the amount of tax imposed for the taxable year directly at issue, as well as for any taxable year indirectly affected through, for example, net operating loss carrybacks or carryforwards. On the other hand, a transaction or item would not affect the determination of the amount of tax imposed for any taxable year other than the taxable year directly at issue solely by reason of any similarity of issues involved. Similarly, a transaction or item would not affect the determination of the amount of tax imposed on any taxpayer unrelated to the taxpayer to whom the summons is directed.

4. Rate of interest for large corporate underpayments (sec. 11341 of the 1990 Act and sec. 6621(c) of the Code)

Present Law

The rate of interest otherwise applicable to

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2 H. Rep. No. 247, 101st Cong., 1st Sess. 1301 (1989); Explanation of Provisions Approved by the Committee on October 3, 1989," Senate Finance Committee Print, 101st Cong., 1st Sess. 118 (October 12, 1989).

3 "Legislative History of Ways and Means Democratic Alternative," House Ways and Means Committee Print (WMCP: 101-37), 101st Cong., 2nd Sess. 58 (October 15, 1990); Report language submitted by the Senate Finance Committee to the Senate Budget Committee on S. 3299, 136 Cong. Rec. S 15629, S 15700 (1990).

underpayments of tax is increased by two percent in the case of large corporate underpayments (generally defined to exceed $100,000), applicable to periods after the 30th day following the earlier of a notice of proposed deficiency, the furnishing of a statutory notice of deficiency, or an assessment notice issued in connection with a nondeficiency procedure.

Description of Proposal

The proposal would provide that an IRS notice that is later withdrawn because it was issued in error does not trigger the higher rate of interest. The proposal also would correct an incorrect reference to "this subtitle".

D. Expiring Tax Provisions

1. Exclusion for employer-provided educational assistance (sec. 11403 of the 1990 Act and secs. 127 and 132 of the Code)

Present Law

Employer-provided educational assistance is excludable from gross income if the value of the assistance does not exceed $5,250 and certain other requirements are satisfied (sec. 127). Prior to the 1990 Act, the exclusion did not apply to graduate level courses. The 1990 Act eliminated this restriction. The Omnibus Budget Reconciliation Act of 1989 provided that educational assistance that is not excludable under section 127 due to the dollar limitation on the exclusion and the restriction on graduate level courses is excludable from gross income if and only if it qualifies as a working condition fringe benefit (sec. 132(h)).

Description of Proposal

The proposal would amend the fringe benefit rules to reflect the fact that the graduate level course restriction has been repealed.

2. Research credit provision: Effective date for repeal of special proration rule (sec. 11402 of the 1990 Act)

Present Law

The Omnibus Budget Reconciliation Act of 1989 effectively extended the research credit for nine months by prorating certain qualified research expenses incurred before January 1, 1991. The special rule to prorate qualified research expenses applied in the case of any taxable year which began before October 1, 1990, and ended after September 30, 1990. Under this special proration rule, the amount of qualified research expenses incurred by a taxpayer prior to January 1, 1991, was multiplied by the ratio that the number of days in that taxable year before October 1, 1990, bears to the total number of days in such taxable year before January 1, 1991. The amendments made by the 1989 Act to the research credit (including the new method for calculating a taxpayer's base amount) generally were effective for taxable years beginning after December 31, 1989. However, this effective date did not apply to the special proration rule (which applied to any taxable year which began prior to October 1, 1990--including some years which began before December 31, 1989--if such taxable year ended after September 30, 1990).

Section 11402 of the Omnibus Budget Reconciliation Act of 1990 extended the research credit through December 31, 1991, and repealed the special proration rule provided for by

the 1989 Act. Section 11402 of the 1990 Act was effective for taxable years beginning after December 31, 1989. Thus, in the case of taxable years beginning before December 31, 1989, and ending after September 30, 1990 (e.g., a taxable year of November 1, 1989 through October 31, 1990), the special proration rule provided by the 1989 Act would continue to apply.

Description of Proposal

The proposal would repeal for all taxable years ending after December 31, 1989, the special proration rule provided for by the 1989 Act.

E. Energy Tax Provision: Alternative Minimum Tax Adjustment Based on Energy Preferences (sec. 11531(a) of the 1990 Act and sec. 56(h) of the Code)

Present Law

In computing alternative minimum taxable income (and the adjusted current earnings (ACE) adjustment of the alternative minimum tax), certain adjustments are made to the taxpayer's regular tax treatment for intangible drilling costs (IDCs) and depletion. A special energy deduction is also allowed. The special energy deduction is initially determined by determining the taxpayer's (1) intangible drilling cost preference and (2) the marginal production depletion preference. The intangible drilling cost preference is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to the adjustments for IDCs. The marginal production depletion preference is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to depletion adjustments attributable to marginal production. The intangible drilling cost preference is then apportioned between (1) the portion of the preference related to qualified exploratory costs and (2) the remaining portion of the preference. The portion of the preference related to qualified exploratory costs is multiplied by 75 percent and the remaining portion is multiplied by 15 percent. The marginal production depletion preference is multiplied by 50 percent. The three products described above are added together to arrive at the taxpayer's special energy deduction (subject to certain limitations).

The special energy deduction is not allowed to the extent that it exceeds 40 percent of alternative minimum taxable income determined without regard to either this special energy deduction or the alternative tax net operating loss deduction. Any special energy deduction amount limited by the 40-percent threshold may not be carried to another taxable year. In addition, the combination of the special energy deduction, the alternative minimum tax net operating loss and the alternative minimum tax foreign tax credit cannot generally offset, in the aggregate, more than 90 percent of a taxpayer's alternative minimum tax determined without such attributes.

Description of Proposal

Interaction of special energy deduction with net operating loss and investment tax credit

The proposal would clarify that the amount of alternative tax net operating loss that is utilized in any taxable year is to be appropriately adjusted to take into account the amount of special energy deduction claimed for

that year. This would operate to preserve a portion of the alternative tax net operating loss carryover by reducing the amount of net operating loss utilized to the extent of the special energy deduction claimed, which if unused, could not be carried forward.

In addition, the proposal would contain a similar provision which clarifies that the limitation on the utilization of the investment tax credit for purposes of the alternative minimum tax is to be determined without regard to the special energy deduction.

Interaction of special energy deduction with adjustment based on adjusted current earnings

The proposal would provide that the ACE adjustment is to be computed without regard to the special energy deduction. Thus, the proposal would specify that the ACE adjustment is equal to 75 percent of the excess of a corporation's adjusted current earnings over its alternative minimum taxable income computed without regard to either the ACE adjustment, the alternative tax net operating loss deduction, or the special energy deduction.

F. Estate Tax Freezes (sec. 11602 of the 1990 Act and secs. 2701-04 of the Code)

Present Law

Generally

The value of property transferred by gift or includible in the decedent's gross estate is its fair market value. Fair market value is generally the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031). Chapter 14 contains rules that supersede the willing buyer, willing seller standard (Code secs. 2701-04).

Preferred interests in corporations and partnerships

Valuation of retained interests

Scope.--Section 2701 provides special rules for valuing certain rights retained in conjunction with the transfer to a family member of an interest in a corporation or partnership. These rules apply to any applicable retained interest held by the transferor or an applicable family member immediately after the transfer of an interest in such entity. An "applicable family member" is, with respect to any transferor, the transferor's spouse, ancestors of the transferor and the spouse, and spouses of such ancestors.

An applicable retained interest is an interest with respect to which there is one of two types of rights ("affected rights"). The first type of affected right is a liquidation, put, call, or conversion right, generally defined as any liquidation, put, call, or conversion right, or similar right, the exercise or nonexercise of which affects the value of the transferred interest. The second type of affected right is a distribution right[4] in an entity in which the transferor and applicable family members hold control immediately before the transfer. In determining control, an individual is treated as holding any interest held by the individual's brothers, sisters and lineal descendents. A distribution right does not include any right with respect to a junior equity interest.

Valuation.--Section 2701 contains two rules for valuing

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[4] A distribution right generally is a right to a distribution from a corporation with respect to its stock, or from a partnership with respect to a partner's interest in the partnership.

applicable retained interests. Under the first rule, an affected right other than a right to qualified payments is valued at zero. Under the second rule any retained interest that confers (1) a liquidation, put, call or conversion right and (2) a distribution right that consists of the right to receive a qualified payment is valued on the assumption that each right is exercised in a manner resulting in the lowest value for all such rights (the "lowest value rule"). There is no statutory rule governing the treatment of an applicable retained interest that confers a right to receive a qualified payment, but with respect to which there is no liquidation, put, call or conversion right.

A qualified payment is a dividend payable on a periodic basis and at a fixed rate under cumulative preferred stock (or a comparable payment under a partnership agreement). A transferor or applicable family member may elect not to treat such a dividend (or comparable payment) as a qualified payment. A transferor or applicable family member also may elect to treat any other distribution right as a qualified payment to be paid in the amounts and at the times specified in the election.

Inclusion in transfer tax base.--Failure to make a qualified payment valued under the lowest value rule within four years of its due date generally results in an inclusion in the transfer tax base equal to the difference between the compounded value of the scheduled payments over the compounded value of the payments actually made. The Treasury Department has regulatory authority to make subsequent transfer tax adjustments in the transfer of an applicable retained interest to reflect the increase in a prior taxable gift by reason of section 2701.

Generally, this inclusion occurs if the holder transfers by sale or gift the applicable retained interest during life or at death. In addition, the taxpayer may, by election, treat the payment of the qualified payment as giving rise to an inclusion with respect to prior periods.

The inclusion continues to apply if the applicable retained interest is transferred to an applicable family member. There is no inclusion on a transfer of an applicable retained interest to a spouse for consideration or in a transaction qualifying for the marital deduction but subsequent transfers by the spouse are subject to the inclusion. Other transfers to applicable family members result in an immediate inclusion as well as subjecting the transferee to subsequent inclusions.

Minimum value of residual interest

Section 2701 also establishes a minimum value for a junior equity interest in a corporation or partnership. For

partnerships, a junior equity interest is an interest under which the rights to income and capital are junior to the rights of all other classes of equity interests.

Trusts and term interests in property

The value of a transfer in trust is the value of the entire property less the value of rights in the property retained by the grantor. Section 2702 provides that in determining the extent to which a transfer of an interest in trust to a member of the transferor's family is a gift, the value of an interest retained by the transferor or an applicable family member is zero unless such interest takes certain prescribed forms.

For a transfer with respect to a specified portion of property, section 2702 applies only to such portion. The section does not apply to the extent that the transfer is incomplete.

Description of Proposal

Preferred interests in corporations and partnerships

Valuation

The proposal would provide that an applicable retained interest conferring a distribution right to qualified payments with respect to which there is no liquidation, put, call, or conversion right is to be valued without regard to section 2701. The proposal also would provide that the retention of such right gives rise to potential inclusion in the transfer tax base. In making these changes, Treasury regulations could provide, in appropriate circumstances, that a right to receive amounts on liquidation of the corporation or partnership constitutes a liquidation right within the meaning of section 2701 if the transferor, alone or with others, holds the right to cause liquidation.

The proposal would modify the definition of junior equity interest by granting regulatory authority to treat a partnership interest with rights that are junior with respect to either income or capital as a junior equity interest. The proposal also would modify the definition of distribution right by replacing the junior equity interest exception with an exception for a right under an interest that is junior to the rights of the transferred interest. As a result, section 2701 would not affect the valuation of a transferred interest that is senior to the retained interest, even if the retained interest is not a junior equity interest.

The proposal would modify the rules for electing into or out of qualified payment treatment. A dividend payable on a

periodic basis and at a fixed rate under a cumulative preferred stock held by the transferor would be treated as a qualified payment unless the transferor elects otherwise. If held by an applicable family member, such stock would not be treated as a qualified payment unless the holder so elects. In addition, a transferor or applicable family member holding any other distribution right may treat such right as a qualified payment to be paid in the amounts and at the times specified in the election.

Inclusion in transfer tax base

The proposal would grant the Treasury Department regulatory authority to make subsequent transfer tax adjustments to reflect the inclusion of unpaid amounts with respect to a qualified payment. This authority, for example, would permit the Treasury Department to eliminate the double taxation that might occur if, with respect to a transfer, both the inclusion and the value of qualified payment arrearages were included in the transfer tax base. It would also permit elimination of the double taxation that might result from a transfer to a spouse, who, under the statute, is both an applicable family member and a member of the transferor's family.

The proposal would treats a transfer to a spouse falling under the annual exclusion the same as a transfer qualifying for the marital deduction. Thus, no inclusion would occur upon the transfer of an applicable retained interest to a spouse, but subsequent transfers by the spouse would be subject to inclusion. The proposal also would clarify that the inclusion continues to apply if an applicable family member transfers a right to qualified payments to the transferor.

The proposal would clarify the consequences of electing to treat a distribution as giving rise to an inclusion. Under the proposal, the election would give rise to an inclusion only with respect to the payment for which the election is made. The inclusion with respect to other payments would be unaffected.

Trust and term interests in property

The proposal would conform section 2702 to existing regulatory terminology by substituting the term "incomplete gift" for "incomplete transfer." In addition, the proposal would limit the exception for incomplete gifts to instances in which the entire gift is incomplete. The Treasury Department would be granted regulatory authority, however, to create additional exceptions not inconsistent with the purposes of the section. This authority, for example, could be used to except a charitable trust that meets the requirements of section 664 and that does not otherwise

create an opportunity for transferring property to a family member free of transfer tax.

G. Miscellaneous Provisions

1. Conforming amendments to the repeal of the General Utilities doctrine (sec. 11702(e)(2) of the 1990 Act and secs. 897(f) and 1248 of the Code)

Present Law

As a result of changes made by recent tax legislation, gain is generally recognized on the distribution of appreciated property by a corporation to its shareholders. The Technical Corrections subtitle of the 1990 Act and technical correction provisions in prior acts made various conforming amendments arising out of these changes. For example, the 1990 Act made a conforming change to section 355(c) to state the treatment of distributions in section 355 transactions in the affirmative rather than by reference to the provisions of section 311. In addition, the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act") made a conforming change to section 1248(f) to update the references to the nonrecognition provisions contained in that subsection. One of the changes was to change the reference to "section 311(a)" from "section 311".

Description of Proposal

The proposal would make three conforming changes to the Code.

First, section 897(f), relating to the basis in a United States real property interest distributed to a foreign person, would be repealed as deadwood. The basis of the distributed property would be its fair market value in accordance with section 301(d).

Second, section 1248(f) would be amended to add a reference to section 355(c)(1), which provides generally for the nonrecognition of gain or loss on the distribution of stock or securities in certain subsidiary corporations. This proposal would retain the substance of the law as it existed before the conforming change to section 355(c) made by the 1990 Act.

Third, section 1248 would be amended to clarify that, notwithstanding the conforming changes made by the 1988 Act, with respect to any transaction in which a U.S. person is treated as realizing gain from the sale or exchange of stock of a controlled foreign corporation, the U.S. person would be treated as having sold or exchanged the stock for purposes of applying section 1248. Thus if a U.S. person distributes appreciated stock of a controlled foreign corporation to its shareholders in a transaction in which gain is recognized under section 311(b), section 1248 would be applied as if the stock had been sold or exchanged at its fair market value.

Under section 1248(a), part or all of the gain may be treated as a dividend. Under the proposal, the rule treating the distribution for purposes of section 1248 as a sale or exchange also would apply where the U.S. person is deemed to distribute the stock under the provisions of section 1248(i). Under section 1248(i), gain would be recognized only to the extent of the amount treated as a dividend under section 1248.

These amendments would not affect the authority of the Secretary to issue regulations under section 1248(f) providing exceptions to the rule recognizing gain in certain distributions (cf. Notice 87-64, 1987-2 C.B. 375).

2. Effective date of LIFO adjustment for purposes of computing adjusted current earnings (sec. 11701 of the 1990 Act, sec. 7611(b) of the 1989 Act, and sec. 56(g) of the Code)

Present Law

For purposes of computing the adjusted current earnings (ACE) component of the corporate alternative minimum tax, taxpayers are required to make the LIFO inventory adjustments provided in section 312(n)(4) of the Code. Section 312(n)(4) generally is applicable for purposes of computing earnings and profits in taxable years beginning after September 30, 1984. The ACE adjustment generally is applicable to taxable years beginning after December 31, 1989.

Description of Proposal

The proposal would clarify that the LIFO inventory adjustment required for ACE purposes would be computed by applying the rules of section 312(n)(4) only with respect to taxable years beginning after December 31, 1989. The effective date applicable to the determination of earnings and profits (September 30, 1984) would be is inapplicable for purposes of the ACE LIFO inventory adjustment. Thus, the ACE LIFO adjustment would be computed with reference to increases (and decreases, to the extent provided in regulations) in the ACE LIFO reserve in taxable years beginning after December 31, 1989.

3. Low-income housing credit (sec. 11701(a)(11) of the 1990 Act and sec. 42 of the Code)

Present Law

The amendments to the low-income housing tax credit contained in the Omnibus Budget Reconciliation Act of 1989 generally were effective for a building placed in service after December 31, 1989, to the extent the building was financed by tax-exempt bonds ("a bond-financed building").

This rule applied regardless of when the bonds were issued.

A technical correction enacted in the Omnibus Budget Reconciliation Act of 1990 limited this effective date to buildings financed with bonds issued after December 31, 1989. Thus, the technical correction applied pre-1989 Act law to a bond-financed building placed in service after December 31, 1989, if the bonds were issued before January 1, 1990.

Description of Proposal

The proposal would repeal the 1990 technical correction. The proposal would provide, however, that pre-1989 Act law would apply to a bond-financed building if the owner of the building establishes to the satisfaction of the Secretary of the Treasury reasonable reliance upon the 1990 technical correction.

In the case of buildings placed in service before the date of the proposal's enactment, reasonable reliance could be established by a showing of compliance with the law as in effect for those buildings before enactment of these proposals.

H. Expired or Obsolete Provisions ("Deadwood Provisions") (secs. 11801-11816 of the 1990 Act)

Present Law

The 1990 Act repealed and amended numerous sections of the Code by deleting obsolete provisions ("deadwood"). These amendments were not intended to make substantive changes to the tax law.

Description of Proposal

The proposal would make several amendments to restore the substance of prior law which was inadvertently changed by the deadwood provisions of the 1990 Act. These amendments would include (1) a provision restoring the prior-law depreciation treatment of certain energy property (sec. 168(e)(3)(B)(vi)); (2) a provision restoring the prior-law definition of property eligible for expensing (sec. 179(d)); (3) a provision restoring the prior-law rule providing that if any member of an affiliated group of corporations elects the credit under section 901 for foreign taxes paid or accrued, then all members of the group paying or accruing such taxes must elect the credit in order for any dividend paid by a member of the group to qualify for the 100-percent dividends received deduction (sec. 243(b)); and (4) the provisions relating to the collection of State individual income taxes (secs. 6361-6365).

The proposal also would make several nonsubstantive clerical amendments to conform the Code to the amendments made by the deadwood provisions. None of these amendments would change the substance of pre-1990 law.

Other Tax Technical Corrections

A. Hedge Bonds (sec. 11701 of the 1990 Act and sec. 149(g) of the Code)

Present Law

The 1989 Act provided generally that interest on hedge bonds is not tax-exempt unless prescribed minimum percentages of the proceeds are reasonably expected to be spent at set intervals during the five-year period after issuance of the bonds (sec. 149(g)). A hedge bond is defined generally as a bond (1) at least 85 percent of the proceeds of which are not reasonably expected to be spent within three years following issuance and (2) more than 50 percent of the proceeds of which are invested at substantially guaranteed yields for four years or more.

This restriction does not apply to hedge bonds, however, if at least 95 percent of the proceeds are invested in other tax-exempt bonds (not subject to the alternative minimum tax). The 95-percent investment requirement is not violated if investment earnings exceeding five percent of the proceeds are temporarily invested for up to 30 days pending reinvestment in taxable (including alternative minimum taxable) investments.

Description of Proposal

The proposal would clarify that the 30-day exception for temporary investments of investment earnings applies to amounts (i.e., principal and earnings thereon) temporarily invested during the 30-day period immediately preceding redemption of the bonds as well as such periods preceding reinvestment of the proceeds.

B. Withholding on Distributions from U.S. Real Property Holding Companies (sec. 129 of the Deficit Reduction Act of 1984 and sec. 1445 of the Code)

Present Law

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), a foreign investor that disposes of a U.S. real property interest generally is required to pay tax on any gain on the disposition. For this purpose a U.S. real property interest generally includes stock in a domestic corporation that is a U.S. real property holding corporation ("USRPHC"), or was a USRPHC at any time during the previous five years.

A sale or exchange of stock in a USRPHC is an example of a disposition of a U.S. real property interest. In addition, provisions of subchapter C of the Code treat amounts received in certain corporate distributions as amounts received in sales or exchanges, giving rise to tax liability under the FIRPTA rules when a foreign person receives such a distribution from a present or former USRPHC. Thus, amounts received by a foreign shareholder in a USRPHC in a distribution in complete liquidation of the USRPHC are treated as in full payment in exchange for the USRPHC stock, and are therefore subject to tax under FIRPTA (sec. 331; Treas. Reg. sec. 1.897-5T(a)(2)(iii)). Similarly, amounts received by a foreign shareholder in a USRPHC upon redemption of the USRPHC stock are treated as a distribution in part or full payment in exchange for the stock, and are therefore subject to tax under FIRPTA (sec. 302(a); Treas. Reg. sec. 1.897-5T(a)(2)(ii)). Third, amounts received by a foreign shareholder in a USRPHC, in a section 301 distribution from the USRPHC that exceeds the available earnings and profits of the USRPHC, are treated as gain from the sale or exchange of the shareholder's USRPHC stock to the extent that they exceed the shareholder's adjusted basis in the stock; such amounts are therefore also subject to tax under FIRPTA (sec. 301(c)(3); Treas. Reg. sec. 1.897-5T(a)(2)(i)).

FIRPTA withholding

The Tax Reform Act of 1984 established a withholding system to enforce the FIRPTA tax. Unless an exception applies, a transferee of a U.S. real property interest from a foreign person generally is required to withhold the lesser of ten percent of the amount realized (purchase price), or the maximum tax liability on disposition (as determined by the IRS) (sec. 1445).

Although the FIRPTA withholding requirement by its terms generally applies to all dispositions of U.S. real property interests, and subchapter C treats amounts received in certain distributions as amounts received in sales or

exchanges, the FIRPTA withholding provisions also provide express rules for withholding on certain distributions treated as sales or exchanges. Generally, distributions in a transaction to which section 302 (redemptions) or part II of subchapter C (liquidations) applies are subject to 10 percent withholding.[5] Although a section 301 distribution in excess of earnings and profits is also treated as a disposition for purposes of computing the FIRPTA liability of a foreign recipient of the distribution, there is no corresponding withholding provision expressly addressed to the payor of such a distribution.

Description of Proposal

The proposal would clarify that FIRPTA withholding requirements would apply to any section 301 distribution to a foreign person by a domestic corporation that is or was a USRPHC, which distribution is not made out of the corporation's earnings and profits and is therefore treated as an amount received in a sale or exchange of a U.S. real property interest. (The proposal would not alter the withholding treatment of section 301 distributions by such a corporation that are out of earnings and profits.) Under the proposal, the FIRPTA withholding requirements that apply to a section 301 distribution not out of earnings and profits would be similar to the requirements applicable to redemption or liquidation distributions to a foreign person by such a corporation. The proposal would be effective for distributions made after the date of enactment of the proposal. No inference would be intended by the adoption of the proposal as to the FIRPTA withholding requirements applicable to such a distribution under present law.

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5 Under other rules, dividend distributions (i.e., distributions to which sec. 301(c)(1) applies) to foreign persons by U.S. corporations, including USRPHCs, are subject to 30-percent withholding under the Code. Under treaties, the withholding on a dividend may be reduced to as little as 5 or 15 percent.

C. Treatment of Credits Attributable to Working Interests in Oil and Gas Properties (sec. 501 of the Tax Reform Act of 1986 and sec. 469 of the Code)

Present Law

Under present law, a working interest in an oil and gas property which does not limit the liability of the taxpayer is not a "passive activity" for purposes of the passive loss rules (sec. 469). However, if any loss from an activity is treated as not being a passive loss by reason of being from a working interest, any net income from the activity in subsequent years is not treated as income from a passive activity, notwithstanding that the activity may otherwise have become passive with respect to the taxpayer.

Description of Proposal

The proposal would provide that any credit attributable to a working interest in an oil and gas property, in a taxable year in which the activity is no longer treated as not being a passive activity, would not be treated as attributable to a passive activity to the extent of any tax allocable to the net income from the activity for the taxable year. Any credits from the activity in excess of this amount of tax would continue to be treated as arising from a passive activity and would be treated under the rules generally applicable to the passive activity credit.

D. Clarification of Passive Loss Disposition Rule (sec. 501 of the Tax Reform Act of 1986, sec. 1005(a)(2)(A) of the Technical and Miscellaneous Revenue Act of 1988, and sec. 469(g)(1)(A) of the Code)

Present Law

The Tax Reform Act of 1986 provided that if a passive activity is disposed of in a transaction in which all gain or loss is recognized, any overall loss from the activity in the year of disposition is recognized and allowed against income (whether active or passive income).[6] The language of the 1986 Act provided that any loss was allowable, first, against income or gain from the passive activity, second, against income or gain from all passive activities, and finally, against any other income or gain. This rule was rewritten by the technical corrections portion of the Technical and Miscellaneous Revenue Act of 1988. The statutory language (as amended by the 1988 Act) providing for the computation of the overall loss for the taxable year of disposition is not entirely clear where the activity is disposed of at a gain.

Description of Proposal

The proposal would clarify the rule relating to the computation of the overall loss allowed upon the disposition of a passive activity. The proposal would provide that, in a transaction in which all gain or loss is recognized on the disposition of a passive activity, any loss from the activity for the taxable year (taking into account all income, gain, and loss, including gain or loss recognized on the disposition) in excess of any net income or gain from other passive activities for the taxable year would be treated as a loss which is not from a passive activity. The proposal would apply to taxable years beginning after December 31, 1986.

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[6] See S. Rept. 99-313, p. 725.

E. Taxation of Excess Inclusions of a Residual Interest in a REMIC for Taxpayers Subject to Alternative Minimum Tax with Net Operating Losses (sec. 671 of the Tax Reform Act of 1986 and sec. 860E of the Code)

Present Law

Residual Interests in a REMIC

A real estate mortgage investment conduit ("REMIC") is an entity that holds real estate mortgages. All interests in a REMIC must be "regular interests" or "residual interests." A regular interest is an interest the terms of which are fixed on the start-up day, which unconditionally entitles the holder to receive a specified principal amount, and which provides that interest amounts are payable based on a fixed rate (or a variable rate to the extent provided in the Treasury regulations). A residual interest is any interest that is so designated and that is not a regular interest in a REMIC.

Generally, the holder of a residual interest in a REMIC takes into account his daily portion of the taxable income or net loss of such REMIC for each day during which he held such interest. The taxable income of any holder of a residual interest in a REMIC for any taxable year cannot be less than the excess inclusion for the year (sec. 860E). Thus, in general, income from excess inclusions cannot be offset by a net operating loss (or net operating loss carryover) in computing the taxpayer's regular tax.

Alternative minimum tax

Taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular tax. The tax is imposed at a rate of 24 percent (20 percent in the case of a corporation) on alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income generally is the taxpayer's taxable income, as increased or decreased by certain adjustments and preferences.

Because the determination of a taxpayer's alternative minimum taxable income begins with taxable income, a taxpayer holding a residual interest in a REMIC may have positive alternative minimum taxable income even where the taxpayer has a net operating loss for the year.

Description of Proposal

The proposal would provide that the present law rule, that the taxable income of a REMIC residual interest shall not be less than its excess inclusions, would not apply for

purposes of the alternative minium tax. Accordingly, the proposal would permit a net operating loss (and net operating loss carryovers) to offset income from excess inclusions in computing alternative minimum taxable income. Under the proposal, all taxpayers subject to the alternative minimum tax would pay a tax on excess inclusions at the alternative minimum tax rate, regardless of whether the taxpayer has a net operating loss. The proposal would be effective for taxable years beginning after December 31, 1986.

F. Conforming Amendments Relating to Pension Reemployment Rights of Members of the Uniformed Services (sec. 414 of the Code)

Legislative Background and Present Law

Veterans' bill

H.R. 1578 ("Uniformed Services Employment and Reemployment Rights Act of 1991") was passed by the House of Representatives on May 14, 1991. The bill was referred to the Senate Committee on Veterans' Affairs on May 16, 1991. On November 7, 1991, S. 1095 ("Uniformed Services Employment and Reemployment Rights Act of 1991") was reported by the Senate Committee on Veterans' Affairs (S. Rept. 102-203), and is pending before the Senate.

H.R. 1578, as passed by the House, and S. 1095, as reported by the Senate Committee on Veterans' Affairs, each amend chapter 43 of title 38, United States Code, to provide for reemployment rights and benefits for individuals who serve in the uniformed services (i.e., the United States Armed Forces or the commissioned corps of the Public Health Service). Each of the bills provides, among other things, that service in the uniformed services is considered service with the employer for retirement plan benefit accrual purposes; the employer that reemploys the individual is liable for funding any resulting obligation; and the reemployed individual is entitled to any accrued benefits derived from employee contributions to the extent that the individual makes payments to the plan with respect to the contributions.

Internal Revenue Code

Under the Internal Revenue Code, overall limits are provided on contributions and benefits under certain retirement plans. Annual additions with respect to each participant under a qualified defined contribution plan generally are limited to the lesser of $30,000 or 25 percent of compensation. Annual deferrals with respect to each participant under an eligible deferred compensation plan (sec. 457) generally are limited to the lesser of $7,500 or 33-1/3 of includible compensation. There is no provision under present law that permits contributions or deferrals to exceed these annual limits in the case of required contributions with respect to a reemployed member of the uniformed services.

Other requirements for which there is no special provision for required contributions with respect to a reemployed member of the uniformed services include the qualified plan nondiscrimination and coverage rules.

Description of Proposal

The proposal would amend the Internal Revenue Code to provide special rules in the case of certain required contributions ("make-up contributions") with respect to a reemployed member of the uniformed services. The proposal would apply only with respect to contributions to a qualified defined contribution plan or eligible deferred compensation plan (sec. 457) that are required under chapter 43 of title 38, United States Code ("title 38") as in effect on December 31, 1992.

Under the proposal, if any contribution is made by an employer under a qualified defined contribution plan or eligible deferred compensation plan ("individual account plan") with respect to an individual, and such contribution is required by reason of the individual's rights under title 38, then such contribution would not be subject to the generally applicable plan contribution limits in the year in which made.[7] In addition, a plan under which such make-up contribution is made would not be treated as failing to meet any requirement applicable to individual account plans (e.g., nondiscrimination rules, including the average deferral and contribution percentage tests under secs. 401(k) and (m)) solely by reason of the making of such contribution, nor would the make-up contribution be taken into account in applying the plan contribution limits to any other contribution made during the year. Required contributions would be deductible by the employer in the year made, notwithstanding the generally applicable deduction limit on plan contributions (sec. 404(a)), and such contributions would not be taken into account in determining the deductibility of other plan contributions made during the year.

A special rule would apply in the case of make-up contributions of salary reduction and employer matching amounts. Under the proposal, a plan that provides for elective deferrals would be treated as meeting the requirements of title 38 if the employer permits reemployed servicepersons to make additional elective deferrals under the plan during the period which begins on the date of reemployment and has the same length as the period of the individual's absence due to uniformed service (but in no case more than 5 years). The amount of the additional deferrals could not exceed the amount of deferrals that the individual

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7 However, the amount of any make-up contribution could not exceed the aggregate amount of employer contributions that would have been permitted under the plan contribution limits had the individual continued to be employed by the employer during the period of uniformed service.

would have been permitted to make under the plan (without regard to nondiscrimination requirements) had the individual continued to be employed by the employer during the period of uniformed service and received compensation at the same rate as received from the employer immediately before such service.

The employer would be required to match any additional elective deferrals at the same rate that would have been required had the deferrals actually been made during the period of uniformed service. Additional deferrals and employer matching contributions would be treated as required employer contributions for purposes of the rule exempting such contributions from the plan qualification rules described above.

The proposal would clarify that nothing in title 38 could be construed as requiring any earnings (or make-up earnings) to be credited to an employee with respect to any contribution before such contribution is actually made. In addition, nothing in title 38 would require any make-up allocation of any forfeiture, or of any employer contribution which was either (1) voluntary (such as a discretionary profit-sharing contribution) or (2) the total amount of which was determined without reference to the number of, or compensation of, plan participants before being allocated to the accounts of participants. For example, make-up contributions would not be required under a plan that provides for a contribution of a set dollar amount, or set percentage of profits, each year. However, make-up contributions would be required under a plan that provides for contributions based on a percentage of participants' compensation. Any election by an employer to provide credit for such amounts (to the extent permitted under title 38) would be subject to applicable nondiscrimination and other plan qualification standards.

The proposal also would provide that a plan could suspend repayment of a plan loan for the period of uniformed service without adverse consequences to the individual.

Because make-up contributions under the proposal would not be made retroactively, but only after a serviceperson's reemployment, amended tax and information returns generally would not be required.

Effective Date

The proposal would be effective only if the amendments to chapter 43, title 38, United States Code, described above (or substantially similar amendments to such chapter) are enacted in the 102nd Congress. In such case, the proposal would apply in cases in which the employee is reemployed on or after August 1, 1990.

G. Exclusion From Income For Combat Zone Compensation (sec. 112 of the Code)

Present Law

The Code provides that gross income does not include compensation received by a taxpayer for active service in the Armed Forces of the United States for any month during any part of which the taxpayer served in a combat zone (or was hospitalized as a result of such service) (limited to $500 per month for officers). The heading refers to "combat pay," although that term is no longer used to refer to special pay provisions for members of the Armed Forces, nor is the exclusion limited to those special pay provisions (hazardous duty pay (37 U.S.C. sec. 301) and hostile fire or imminent danger pay (37 U.S.C. sec. 310)).

Description of Proposal

The proposal would modify the heading of Code section 112 to refer to "combat zone compensation" instead of "combat pay". The proposal also would make conforming changes to cross-references elsewhere in the Code.

I. Limitation on Deduction for Certain Interest Paid by Corporation to Related Person (sec. 7210(a) of the 1989 Act and sec. 163(j) of the Code)

Present Law

Subject to certain limitations, a taxpayer may deduct interest paid or accrued on indebtedness within a taxable year (sec. 163(a)). The 1989 Act added a so-called "earnings stripping" limitation on interest deductibility with respect to certain interest paid by corporations to related persons (sec. 163(j)). If the provision applies to a corporation for a taxable year, it disallows deductions for certain amounts of "disqualified interest" paid or accrued by the corporation during that year. If in a taxable year a deduction is disallowed, under the provision, for an amount of interest paid or accrued in that year, the disallowed amount is treated under the earnings stripping provision as disqualified interest paid or accrued in the succeeding taxable year.[8]

In order for the earnings stripping provision to apply to a corporation for a taxable year, two thresholds must be exceeded. To exceed the first threshold, the corporation must have "excess interest expense" as that term is defined in the Code for this purpose. To exceed the second threshold, the corporation must have a ratio of debt to equity as of the close of the taxable year in question (or on any other day prescribed by the Secretary in regulations) that exceeds 1.5 to 1. Excess interest expense is the excess (if any) of the corporation's net interest expense over the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward from a prior year. Excess limitation is the excess (if any) of 50 percent of adjusted taxable income over net interest expense.

Description of Proposal

The proposal would provide that the debt-equity threshold would not apply for purposes of applying the earnings stripping provision to a carryover of excess interest expense from a prior taxable year. Thus, the proposal would clarify that excess interest carried forward from a year in which the debt-equity ratio threshold is

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[8] Disqualified interest is interest paid by a corporation to related persons that are not subject to U.S. tax on the interest received. (If, in accordance with a U.S. income tax treaty, interest income of a related person is subject to a reduced rate of U.S. tax, a portion of the interest paid to the related person is deemed to be interest on which no tax is imposed.)

exceeded could be deducted in a subsequent year in which that threshold is not exceeded, but only to the extent that such interest would not otherwise be treated as excess interest expense in the carryforward year.

J. Branch-Level Interest Tax (sec. 1241 of the 1986 Act and sec. 884 of the Code)

Present Law

Interest paid (or treated as if paid) by a U.S. trade or business (i.e., a U.S. branch) of a foreign corporation is treated as if paid by a U.S. corporation and, hence, is U.S. source and subject to U.S. withholding tax of 30 percent, unless the tax is reduced or eliminated by a specific Code or treaty provision. The Treasury has regulatory authority to limit U.S. sourcing, and hence U.S. withholding, to the amount of interest reasonably expected to be deducted in arriving at the U.S. branch's effectively connected taxable income.

To the extent a U.S. branch of a foreign corporation has allocated to it under Treasury Regulation section 1.882-5 an interest deduction in excess of the interest actually paid by the branch (this generally occurs where the indebtedness of the U.S. branch is disproportionately small compared to the total indebtedness of the foreign corporation), the excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary (the U.S. branch, in actuality) from its foreign corporate parent (the home office). This excess is subject to the 30-percent tax, absent a specific Code exemption or treaty reduction (sec. 884(f)(1)(B)).

These branch-level interest taxes, along with the branch profits tax, were intended to reflect the view that a foreign corporation doing business in the United States generally should be subject to the same substantive tax rules that apply to a foreign corporation operating in the United States through a U.S. subsidiary.[9] Where a U.S. corporation pays interest to its foreign corporate parent, that interest, like the interest deducted by a U.S. branch of a foreign corporation, is also generally subject to a 30-percent U.S. withholding tax unless the tax is reduced by treaty. In the case of a U.S. subsidiary of a foreign parent corporation, the withholding tax applies without regard to whether the interest payment is currently deductible by the U.S. subsidiary. For example, deductions for interest may be delayed or denied under section 163, 263, 263A, 266, 267, or

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[9] Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 1036 (1987).

469, but it is still subject (or not subject) to withholding when paid without regard to the operation of those provisions.

Description of Proposal

The proposal would provide that the branch level interest tax on interest not actually paid by the branch would apply to any interest which is allocable to income which is effectively connected with the conduct of a trade or business in the United States. Similarly, in the case of interest paid by the U.S. branch, the proposal would provide regulatory authority to limit U.S. sourcing, and hence U.S. withholding, to the amount of interest reasonably expected to be allocable to income which is effectively connected with the conduct of a trade or business in the United States. Thus, where an interest expense of a foreign corporation is allocable to U.S. effectively connected income, but that interest expense would not have been fully deductible for tax purposes under another Code provision had it been paid by a U.S. corporation, the proposal would clarify that such interest would nonetheless be treated for branch level interest tax purposes like a payment by a U.S. corporation to a foreign corporate parent. Similarly, with regard to the Treasury's regulatory authority to treat an interest payment by a foreign corporation's U.S. branch as though not paid by a U.S. person for source and withholding purposes, the proposal would clarify that the authority extends to interest payments in excess of those reasonably expected to be allocable to U.S. effectively connected income of the foreign corporation.

K. Determination of Source in Case of Sales of Inventory Property (sec. 211 of the 1986 Act and sec. 865(b) of the Code)

Present Law

Prior to the 1986 Act, the source of income derived from the sale of personal property generally was determined by the place of sale (commonly referred to as the "title passage" rule) (see, e.g., Treas. Reg. sec. 1.861-7, T.D. 6258, 1957-2 C.B. 368). While the 1986 Act generally replaced the place-of-sale rule for sales of personal property with a residence-of-the-seller rule (sec. 865(a)), the Act did not change the place-of-sale rule for most sales of inventory property (sec. 865(b)).

Before and after the 1986 Act, statutory rules for sourcing income from inventory sales have included those covering income from (i) purchasing inventory property outside the United States (other than within a U.S. possession) and selling it in the United States (sec. 861(a)(6)); (ii) purchasing inventory property in the United States and selling it outside the United States (sec. 862(a)(6)); (iii) selling outside the United States inventory property which has been produced by the taxpayer in the United States (or selling in the United States inventory property which has been produced by the taxpayer outside the United States) (sec. 863(b)(2)); and (iv) purchasing inventory property in a U.S. possession and selling it in the United States (sec. 863(b)(3)). Prior to the 1986 Act, these provisions were not limited in application to income from sales of inventory property, but rather covered sales of personal property generally.

In addition to statutory rules for sourcing items of income from transactions involving inventory property specified in the Code, such as those listed above, the Code both before and after the 1986 Act has contained other sourcing rules that do not make specific reference to property sales, and includes general regulatory authority to allocate and apportion between U.S. and foreign sources items of gross income, expenses, losses, and deductions other than those specified in sections 861(a) and 862(a) (sec. 863(a)). In carving income from the sale inventory property out of the general residence-of-the-seller rule of section 865, section 865(b) makes reference to the above statutory rules making specific reference to inventory property, but not to the general grant of regulatory authority in section 863(a).

Description of Proposal

The proposal would modify the general provision relating to the sourcing of income from the sale of personal property (section 865) so that the cross-reference to sourcing rules

applicable to inventory property would include a reference to all of section 863, rather than simply to section 863(b). The proposal thus would clarify that, to the extent that the Treasury Secretary had general regulatory authority to provide rules for the sourcing of income from the sales of personal property prior to the 1986 Act, the Treasury Secretary would retain that authority under present law with respect to inventory property. For example, the intent of this proposal would not increase the Treasury Secretary's regulatory authority under section 863(a) beyond the authority that he had under the law in effect prior to the enactment of the 1986 Act. The proposal would clarify that no inference be drawn from this proposal either as to the correctness of, or as to the post-1986 Act implications of, any judicial decision interpreting the scope of that pre-1986 Act authority.

L. Repeal of Obsolete Provisions (sec. 10202 of the 1987 Act and secs. 6038(a)(1)(F) and 6038A(b)(4) of the Code)

Present Law

A U.S person who controls a foreign corporation must report certain information related to that foreign corporation as may be required by the Treasury Secretary (Code sec. 6038). Information reporting is also required with respect to certain foreign-owned domestic corporations (Code sec. 6038A). Included under each of these information reporting provisions is a requirement to report such information as the Treasury Secretary may require for purposes of carrying out the provisions of section 453C. Section 453C, relating to certain indebtedness treated as payment on installment obligations (the so-called "proportional disallowance rule"), was repealed in the Revenue Act of 1987.

Description of Proposal

The proposal would repeal as obsolete the information reporting requirements of sections 6038 and 6038A relating to section 453C.

Technical Corrections Related to Tariff and Customs

Tariff and Customs Provisions

A. Removal of GDR from Column 2 Rate List (General Note 3(b) to the Harmonized Tariff Schedule of the United States)

Present Law

General Note 3(b) to the HTSUS listed the "German Democratic Republic" among the countries subject to higher column 2 rates of duty. On October 2, 1991, the President acted to remove this designation (Presidential Proclamation 6343).

Description of Proposal

Following German reunification, on October 31, 1990, most-favored-nation (MFN) column 1 tariff treatment already granted to West Germany was extended automatically to the former East Germany (GDR). The Chairman's proposal recognizes these developments by eliminating reference to the GDR from the HTSUS. Inclusion of this provision is necessary, notwithstanding the action of the President on October 2, 1991, in view of the Legislative Branch's exclusive authority with regard to import duties under Article I, section 8 of the Constitution.

B. Tapestry and Upholstery Fabrics (sec. 472(b) of the Customs and Trade Act of 1990; Part II, sec. 10011(a) of the Omnibus Budget Reconciliation Act of 1990; and subheading 5112.19.20 to the HTS)

Present Law

The Customs and Trade Act of 1990 (P.L. 101-382, (hereafter referred to as "the Trade Act of 1990") added several new subheadings to headings 5111 and 5112 of the HTSUS for tapestry fabrics and upholstery fabrics of a weight exceeding 300 grams per square meter. This had the effect of reducing the tariff rate from 36.1 ad valorem to seven percent ad valorem for these fabrics. New HTSUS subheading 5112.19.10 was renumbered as 5112.19.20 in the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508 (hereinafter referred to as "the Budget Reconciliation Act").

Description of Proposal

Addition of the words "of a weight exceeding 300 g/m2" to HTSUS subheading 5112.19.20 had the effect of inadvertently raising the column 1 duty rate on certain lighter weight tapestry and upholstery fabrics, which are now classified in subheading 5112.19.60 due to the weight criterion in subheading 5112.19.20. The Chairman's proposal

deletes those words in order to restore prior HTSUS tariff treatment. The change applies retroactively to allow importers to apply for reassessment of duties levied since October 1, 1990, using the higher rate.

C. Gloves (Part II, sec. 10011, (a), (b)(2), and (b)(6) of the Budget Reconciliation Act; and Chapter 61 and 62 to the HTS)

Present Law

In the Budget Reconciliation Act, HTSUS subheading 6216.00.47 was deleted; subheading 6216.00.49 was redesignated as 6216.00.52 and it was indented so that its description aligned with that of subheading 6216.00.46 (which had been redesignated from 6216.00.44). The Budget Reconciliation Act also redesignated subheading 6116.10.25 as 6116.10.45. The tariff treatment of these gloves had been modified by the Trade Act of 1990.

Description of Proposal

When the above changes were made, the superior text "Other", placed just above the deleted 6216.00.47, inadvertently was not stricken. The Chairman's proposal strikes the word "Other". The Chairman's proposal also redesignates new HTSUS subheading 6116.10.45 as 6116.10.48 in order to avoid reusing a previously used subheading number. These corrections will avoid confusion in classifying goods and comparing trade data.

D. Agglomerate Stone Floor and Wall Tiles (sec. 484B and 485(b) of the Trade Act and subheading 6810.19.12 to the HTS)

Present Law

The Trade Act of 1990 added a new HTSUS subheading 6810.19.12 for agglomerate marble floor tiles. This had the effect of reducing the applicable tariff rate from 21 percent *ad valorem* to 4.9 percent *ad valorem* for these types of tiles. The provision as written applies only to geological marble and not to other types of materials that may be commonly referred to as "marble" but are not recognized as such by the Explanatory Notes to the Harmonized Commodity Description and Coding System, as interpreted and applied by the U.S. Customs Service.

Description of Proposal

The Chairman's proposal changes the description for HTSUS subheading 6810.19.12 from "agglomerate marble tiles" to "floor and wall tiles of stone agglomerated with binders other than cement." This rewording covers tiles produced from chips or dust of various natural stones mixed with a plastic resin binding material. The change applies retroactively to allow importers to apply for reassessment of duties levied since January 1, 1989, using the higher rate.

E. 2,4-Diaminobenzesulfonic Acid (sec. 349 of the Trade Act and subheading 9902. 30.43 to the HTS)

Present Law

Under HTSUS heading 9902.30.43, which grants a duty suspension to 2,4-Diaminobenzesulfonic acid, "2921.51.50" is cited as the HTSUS subheading under which imports of this chemical enter.

Description of Proposal

The above cited subheading number is incorrect. The Chairman's proposal provides the correct HTSUS subheading (2921.59.50) under which imports of 2,4-Diaminobenzenesulfonic acid enter.

F. Machines Used in the Manufacture of Bicycle Parts (sec. 439 of the Trade Act and subheading 9902.84.79 to the HTS)

Present Law

The Trade Act suspended the duty on machines used to manufacture bicycle wheels by adding a new HTSUS heading, 9902.84.79. The machines covered include "wheeltruing" and "rim punching" machines. Heading 9902.84.79 refers only to HTSUS subheading 8479.89.90 which covers "machines and mechanical appliances."

Description of Proposal

The Chairman's proposal reflects that wheeltruing machines are covered by HTSUS subheading 9031.80.00 and rim punching machines are covered by HTS subheading 8462.49.00. These two additional subheadings are now referenced in heading 9902.84.79. The change applies retroactively to allow importers to apply for reassessment of duties levied since October 1, 1990.

G. Copying Machines and Parts (sec. 462(d)(2) of the Trade Act and subheading 9902. 90.90 to the HTS)

Present Law

HTSUS heading 9902.90.90 provides duty-free treatment for parts and accessories of electrostatic copying machines. The Trade Act of 1990 amended this subheading to cover parts and accessories intended for attachment to electrostatic copiers. Heading 9902.90.90 refers to subheading 8472.90.80 as the provision that covers parts and accessories for attachment to electrostatic copiers.

Description of Proposal

The Chairman's proposal provides that parts intended for attachment to electronic copiers are covered by HTSUS subheading 8473.40.40. This additional subheading is now referenced in heading 9902.90.90. The change applies retroactively to allow importers to apply for reassessment of duties levied since January 1, 1989.

H. Clarification Regarding the Application of Customs User Fees (Title I, Subtitle B, sec. 111(b)(2)(D)(v) of the Trade Act; subparagraph (D) of sec. 13031(b)(8) of the Consolidated Omnibus Budget Reconciliation Act of 1985; and 19 U.S.C. 58c(b)(8)(D)

Present Law

The Trade Act of 1990 provided that, in the case of agricultural products of the United States processed and packed in foreign trade zones, the ad valorem merchandise processing fee (MPF) would be applied solely to the value of the foreign material used to make the container; it exempted the value of the domestic agricultural products from the MPF. Customs has ruled that, for all products not covered by this provision and in the absence of an express provision to the contrary, the MPF will be assessed on both the domestic and foreign value of the merchandise entering from foreign trade zones.

Description of Proposal

The Chairman's proposal clarifies that the MPF is to be applied only to the foreign value of the merchandise entered from a foreign trade zone. The provision applies to all unliquidated entries from foreign trade zones, including processed agricultural products, after November 30, 1986.

I. Technical Amendments to the Omnibus Trade and Competitiveness Act of 1988 (sec. 1102(a) of the Omnibus Trade and Competitiveness Act of 1988 and 19 U.S.C. 2902(a))

Present Law

Section 1102(a) of the Omnibus Trade and Competitiveness Act of 1988 (19 U.S.C. 2902) (hereafter referred to as "the Trade Act of 1988"), provides the President the authority to proclaim certain tariff reductions pursuant to trade agreements with foreign countries. Paragraph (a)(2) provides the President the authority to reduce tariff rates in existence as of August 23, 1988, at which time the Tariff Schedules of the United States (TSUS) were in effect. Pursuant to Title I, Subtitle B of the Trade Act of 1988, the TSUS were replaced by the HTSUS effective January 1, 1989.

Tariff negotiations in the Uruguay Round of Multilateral Trade Negotiations have been conducted on the basis of U.S. tariff rates under the HTSUS rather than under the TSUS.

Description of Proposal

The Chairman's proposal amends the Trade Act of 1988 to reflect the fact that any tariff reductions that might be proclaimed by the President pursuant to section 1102(a) of the Trade Act of 1988 will be based upon the tariff rates under the HTSUS as of January 1, 1989.

J. Technical Amendment to the Customs and Trade Act of 1990 (sec. 484H(b) of the Trade Act and 19 U.S.C. 1553 note)

a. Canadian lottery material

Present Law

The Customs and Trade Act of 1990 provides for transportation in bond of Canadian lottery material.

Description of Proposal

The Chairman's proposal replaces the phrase "entered or withdrawn from warehouse for consumption" in the "Effective Date" section of the Trade Act of 1990 with "entered for transportation in bond". This had been done to clarify that Canadian lottery material is not entered into the United States for consumption.

b. Clarification of leather product provision

Present Law

The Customs and Trade Act amended the Caribbean Basin Economic Recovery Act to provide duty reductions on leather products, such as luggage, handbags, flat goods, work gloves, and leather wearing apparel.

Description of Proposal

The Chairman's proposal clarifies that the duty reductions apply only to such products that are made of leather, not those made of textiles and subject to textile agreements.

K. Clarification Regarding the Provision of Daytime Reimbursable Services

Present Law

19 U.S.C. 58(c) authorizes the Customs Service to provide reimbursable services to air couriers operating in

express consignment carrier facilities and in centralized hub facilities. In September 1990, Customs interpreted the present statute to prevent Customs from providing reimbursable services during daytime hours to centralized hub facilities, but to permit Customs to provide such services to express consignment carrier facilities. In June 1992, the Comptroller General also ruled that, under current law, Customs could not provide daytime reimbursable services to centralized hub facilities.

Description of Proposal

The Chairman's proposal would clarify that Customs could provide daytime reimbursable services to both express consignment carrier facilities and to centralized hub facilities. It also would clarify that Customs could be reimbursed for all services related to the determination to release cargo, and not just "inspectional" services. These services include the costs of Customs inspectors and aides, canines, and entry data processors.

Additional Pension Tax Technical Corrections: Rollover and Withholding on Nonperiodic Pension Distributions

Present Law

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

A qualified retirement or annuity plan must permit participants to elect to have any distribution that is eligible for rollover treatment paid directly to an eligible retirement plan specified by the participant (sec. 401(a)(31)).

Withholding is imposed at a rate of 20 percent on any distribution that is eligible to be rolled over but that is not paid directly to an eligible retirement plan. However, as under present law, withholding is not required on employer securities.

Description of Proposal

The proposal would clarify that an eligible rollover distribution paid directly to an eligible retirement plan pursuant to section 401(a)(31) is considered to be a plan distribution followed by an immediate rollover (a "direct rollover"). A direct rollover is to be distinguished from a trustee-to-trustee transfer under other provisions of the Code.

The proposal would clarify that a participant would be permitted to elect a direct rollover with respect to any portion of an eligible rollover distribution. Withholding at a rate of 20 percent would apply to the portion of the distribution not directly rolled over.

The proposal would clarify that the portion of any eligible rollover distribution that represents unrealized appreciation in employer securities is subject to the direct rollover provisions, notwithstanding the special rules pertaining to net unrealized appreciation (NUA) in employer securities. However, to the extent that amounts attributable to appreciation in employer securities are paid directly to an eligible retirement plan, special NUA treatment no longer applies with respect to such securities. Furthermore, in the case of a distribution other than a lump-sum distribution, if

any portion of a distribution that represents unrealized appreciation in employer securities is paid directly to an eligible retirement plan, special NUA treatment does not apply to the portion of the distribution that is paid to the participant.

The proposal would provide that the following plan distributions are not eligible rollover distributions: (1) hardship distributions of amounts attributable to elective deferrals under qualified cash-or-deferred arrangements (sec. 401(k)) or tax-deferred annuity plans (sec. 403(b)); (2) return of excess deferrals and contributions under qualified cash-or-deferred arrangements; (3) loans treated as distributions under section 72(p) and certain other loans in default that are treated as distributions; (4) certain dividends paid to a plan with respect to employer securities and distributed in cash to participants or their beneficiaries (sec. 404(k)); and (5) so-called "P.S. 58" costs for group term life insurance.

The proposal would clarify that an eligible rollover distribution from a tax-deferred annuity plan could be paid directly to another tax-deferred annuity plan.

The proposal would provide a de minimis exception to the direct rollover requirement, so that a plan would not have to permit a direct rollover of, or withhold upon at a 20-percent rate, distributions of $500 or less. As under present law, such distributions could be rolled over by the participant if the distribution otherwise qualifies as an eligible rollover distribution. It is intended that the Secretary will provide appropriate rules to prevent abuse of the de minimis exception.

The proposal would provide that if the portion of any eligible distribution that is a minimum required distribution (sec. 401(a)(9)) constitutes no more than 10 percent of the portion of such distribution that is not directly rolled over, withholding at a rate of 20 percent applies to the entire portion of the distribution received by the participant.

The proposal would provide that a qualified defined benefit plan is an eligible retirement plan to which direct rollovers may be made, provided the plan permits the acceptance of rollover distributions.

The proposal would provide that a distribution will not fail to be treated as one of a series of substantially equal periodic payments merely because the distribution includes a social security supplement or certain other temporary periodic payments (e.g., certain disability benefits).

The proposal would clarify that, in the case of a series

of periodic payments, the requirement that a written explanation be provided to recipients of eligible rollover distributions (sec. 402(f)) is deemed satisfied if notice is provided within a reasonable period of time before the first payment of such series.

The proposal would provide that plan amendments to comply with the pension provisions under the Unemployment Compensation Amendments Act of 1992 generally are not required to be made before the first plan year beginning on or after January 1, 1995.

Finally, the proposal would provide that the delayed effective date for the direct rollover and withholding provisions applicable to certain tax-deferred annuity plans of State or local governments would be extended to apply to all qualified retirement plans of State and local governments.

Effective Date

The proposal would be effective as if included in the Unemployment Compensation Amendments Act of 1992 (P.L. 102-318).

MEDICARE MISCELLANEOUS AND TECHNICAL AMENDMENTS

A. AMENDMENTS RELATING TO PART A OF THE MEDICARE PROGRAM

1. DRG Payment Window Clarification

Present Law. -- Services provided by a hospital (or an entity wholly owned or operated by the hospital) to an inpatient of a hospital during the three days prior to admission are not separately reimbursed under part B of Medicare if they are diagnostic services or otherwise related to the admission.

Proposal. -- Clarify that this provision does not apply to hospitals that are not paid on the basis of diagnosis related groups (DRGs).

2. Essential Access Community Hospital program

Present Law. -- (a) The Secretary of Health and Human Services is required to make grants to up to seven states to participate in the Essential Access Community Hospital (EACH) program.

(b) The Secretary may designate an urban hospital as an essential access community hospital if it meets the criteria for designation as a rural referral center.

(c) The Secretary may designate a hospital as an essential access community hospital if it is located in a state receiving an EACH program grant.

(d) Rural primary care hospitals are required to have written policies governing the provision of services, and have a physician, physician assistant, or nurse practitioner responsible for the execution of those policies.

(e) Medicare inpatient hospital benefits are subject to the inpatient hospital deductible and to coinsurance after 60 days of hospitalization during a spell of illness.

Proposal. -- (a) The number of states eligible for grants under the EACH program would be increased from seven to nine.

(b) The Secretary would be authorized to designate an urban hospital as an essential access community hospital if the hospital otherwise meets the criteria for designation.

(c) A State receiving a grant under the EACH program would be authorized to designate as an essential access community hospital or a rural primary care hospital a facility in an adjoining state if the facility was otherwise eligible for designation. The Secretary would be authorized to designate a facility as an essential access community hospital or a rural primary care hospital if the facility is not in a state receiving an EACH

program grant if the facility is a member of a rural health network of a state receiving a grant.

(d) The requirements for written policies and procedures and the supervision of those procedures in rural primary care hospitals would be amended to clarify that the requirements are similar to those for hospitals. Specifically, rural primary care hospitals would be required to appoint a physician, as defined in section 1861(r)(1) of the Social Security Act, to supervise the implementation of the policies.

(e) The applicability of the inpatient hospital deductible and coinsurance to stays in rural primary care hospitals would be clarified. Other minor drafting errors would be corrected.

3. Treatment of Certain Military Facilities

Present Law. -- Other than Indian Health Service hospitals, hospitals owned by, or under contract to, the Federal government are not eligible for reimbursement under Medicare. Uniformed services treatment facilities are private hospitals under contract to the federal government. The Assistant Secretary of Defense for Health Affairs has been directed to prepare a report on joint military/civilian health centers.

Proposal. -- The Secretary of Health and Human Services would be prohibited from taking action to recover certain amounts paid by medicare to uniformed services treatment facilities in Boston, Baltimore, and Seattle for services that were provided between October 1, 1986 and December 31, 1989 to members of the uniformed services or their dependents who were also eligible for medicare. The Secretary of Health and Human Services, in consultation with the Secretary of Defense and the Secretary of Veterans Affairs shall conduct a study of the feasibility and desirability of establishing a joint medical facility among the Department of Defense, Department of Veterans Affairs, and other public and private entities. The study shall include the need to make changes in the Medicare and Medicaid programs in order to facilitate the establishment of such joint medical facility.

4. Nursing home reform technical

Present law. -- The Omnibus Budget Reconciliation Act (OBRA) of 1990 included a clerical error in the nursing home reform provisions pertaining to the period of resident assessment.

Proposal. -- The clerical error would be corrected.

B. AMENDMENTS RELATING TO PART B OF THE MEDICARE PROGRAM

1. Physician Payment Provisions

(a) Overvalued Procedures

Present law.-- OBRA 90 subjected all unsurveyed overvalued services to a 6.5 percent reduction unless the law specifically exempted them from the reduction. Unsurveyed services are those not included in earlier surveys conducted to determine relative values of physicians' services; these unsurveyed services were considered to be overvalued.

Proposal.-- The list of services specifically exempted from the 6.5 percent reduction contained certain errors. The provision deletes some procedures from the list of exempted services and corrects errors in the names of other services.

(b) Radiology Services

Present law.-- OBRA 90 reduced the conversion factor for radiology services paid on the basis of a radiology fee schedule to a geographically adjusted amount, not to exceed 9.5 percent. However, as drafted, OBRA 90 contained an error that permits the conversion factors for services below the target to increase.

Proposal.-- The provision would specify that conversion factors below the geographically adjusted amount could not be increased. The provision makes other technical changes to OBRA 90.

(c) Anesthesia Services

Present law.-- OBRA 87 established a fee schedule for anesthesia services based on a relative value guide for anesthesia services and local conversion factors. OBRA 90 reduced local conversion factors to a geographically adjusted amount, not to exceed 9.5 percent. However, as drafted, OBRA 90 contained an error that permits the conversion factors for services below the target to increase.

Proposal.-- The provision would specify that conversion factors below the geographically adjusted amount could not be increased. The provision makes other technical changes to OBRA 90.

(d) Assistants at Surgery

Present law.-- OBRA 90 specified that payment to a physician serving as an assistant at surgery cannot exceed 16 percent of the payment made for the global surgical service.

Proposal.-- The provision clarifies that balance-billing limits apply to physicians serving as assistants at surgery.

(e) Technical Components of Diagnostic Services

Present law.-- OBRA 90 capped the reasonable charge for technical components of specified diagnostic services at the national median charge for the service in all localities.

Proposal.-- The provision specifies that the limits on payment for the technical component of diagnostic services do not apply to services whose payments were reduced under the OBRA 89 overvalued procedure list.

(f) Statewide Fee Schedules

Present law.-- OBRA 90 required the Secretary to treat the States of Nevada and Oklahoma as statewide payment localities if they met certain requirements specified in the law. Each member of the Congressional delegation from those states and organizations representing urban and rural physicians would have to agree to the Statewide locality provision.

Proposal.-- Due to constitutional concerns relating to the separation of powers between the executive and the legislative branches, the provision would eliminate the OBRA 90 requirement for agreement from members of Congress and stipulate instead that Nevada and Oklahoma were statewide localities in 1991.

(g) Reciprocal Billing Arrangements

Present law.-- OBRA 90 permitted physicians to submit a claim for a service provided by a second physician when the first physician was not available to provide the service. Such billing was permitted only in cases where the arrangement is temporary and reciprocal.

Proposal.-- The provision would amend OBRA 90 to clarify services that may be covered under reciprocal billing. All physician services, including services incident to physician services, would be covered. The provision would also permit reciprocal billing arrangements that are both informal or reciprocal (as in current law) or involve per diem or other fee-for-time compensation.

(h) Study of Aggregation Rule for Claims of Similar Physician Services

Present law.-- OBRA 90 required the Secretary to study the effects of aggregating physician claims and report to Congress by December 31, 1992.

Proposal.-- The provision would change the date that the study must be submitted to Congress from December 31, 1992 to December 31, 1993.

(i) Other Miscellaneous and Technical Provisions

OBRA 90 contains a number of technical and drafting errors that are corrected through minor and conforming amendments.

2. Ambulatory Surgical Centers

(a) Payment Amounts

Present law.-- Current law requires the Secretary to update ambulatory surgery center payment rates by July 1, 1987 and annually thereafter, as determined appropriate by the Secretary.

The OBRA 90 conferees had intended to include a provision requiring an annual update to ASC rates, but it was omitted from the law.

Proposal.-- The provision would set the update for ambulatory surgery services, beginning with fiscal year 1994, at the CPI-U for the 12 month period ending with March of the preceding year. The Secretary would be required to conduct a survey, based on a representative sample of procedures and facilities, beginning by July 1, 1993 and updated every 5 years thereafter, of the actual audited costs of ambulatory surgery facilities. The survey results would be used in establishing payment rates. The Secretary would be required to consult with appropriate trade and professional organizations in updating the list of procedures that can be performed in ambulatory surgery centers.

(b) Adjustments to Payment Amounts for New Technology Intraocular Lenses

Present law.-- OBRA 90 included a provision capping payments for IOLs at $200 in 1991 and 1992. As drafted, the statutory language could be interpreted as limiting payments for cataract surgery to $200. The OBRA 90 conferees also agreed to a provision providing for a process by which the fee for new technology intraocular lenses (IOLs) could be adjusted. Statutory language reflecting this agreement was inadvertently omitted from OBRA 90.

Proposal.-- The Secretary would be required to develop and implement a process for reviewing reimbursement for new technology intraocular lenses (IOLs). In order to be considered a new technology IOL, the device would have to be approved by the FDA. The Secretary would also be required to consider specific circumstances in determining whether to adjust the payment amount for new technology IOLs. The provision also specifies administrative procedures for reviewing and approving new technology IOLs.

3. Durable Medical Equipment

(a) Updates to Payment Amounts

Present law.-- OBRA 90 contains a drafting error that specified that the update to the Durable Medical Equipment fee schedule for 1991 and 1992 was minus 1 percent.

Proposal.-- The provision would correct the OBRA 90 error by specifying that the 1991 and 1992 update is the CPI-U minus one percentage point.

(b) Potentially Overused Items and Advance Determinations of Coverage

Present law.-- OBRA 90 included two provisions regarding special carrier review of potentially overutilized items and advance determinations of coverage for certain items. These two provisions were combined in drafting so that they do not properly reflect the conference agreement.

Proposal.-- The provision would modify OBRA 90 with respect to treatment of potentially overused items. The Secretary may add items to the list of potentially overused items if they are marketed directly to beneficiaries, if offers to waive coinsurance are made, if items have been subject to consistent patterns of overutilization, or if a high proportion of claims for an item are denied based on absence of medical necessity. Payment for items on this list cannot be made unless the carrier has subjected the claim to special scrutiny or has determined in advance whether an item is medically necessary and covered by Medicare. Carriers would also be required to made advance coverage decisions for customized items and to meet criteria developed by the Secretary to assure that advance coverage decisions are made on a timely basis.

(c) Study in Variations in Durable Medical Equipment Supplier Costs

Present law.-- OBRA 90 provided for a system of upper and lower limits on DME fees. The OBRA 90 conferees agreed to a study of regional variations in DME equipment supplier costs which was not included in the statutory language.

Proposal.-- The provision would require HCFA to collect data on supplier costs for DME and analyze them to determine costs attributable to service and product components and the extent to which they vary by type of equipment and geographic region. The HCFA administrator would be required to submit a report and recommendations for a geographic cost adjustment index for DME supplies and an analysis of the impact of such an index on Medicare payments.

(d) Oxygen Retesting

Present law.-- OBRA 90 included a provision requiring periodic retesting of beneficiaries receiving oxygen if their initial blood gas reading value was at or above a partial value of 55.

Proposal.-- The provision corrects the OBRA 90 language regarding the arterial blood gas values to require retesting when a beneficiary's initial value is at or above 56.

(e) Other Technical and Conforming Amendments

As drafted, OBRA 90 included several minor technical errors. Technical corrections are made to Sections 4152 and 4153.

4. Other Part B Items and Services

(a) Revision of Information on Part B Claims

Present law.-- Each Part B claim for which the entity submitting the claim knows or has reason to believe that there has been a referral by physician must include the name and provider number of the referring physician and must indicate whether the referring physician is an investor in the entity.

Proposal.-- The provision would require that the claim form include the unique physician identification number (UPIN) and would repeal the requirement that claims indicate whether the referring physician is an investor in the entity.

(b) Consultation for Social Workers

Present law.-- OBRA 90 provided for direct reimbursement for the services of clinical psychologists and clinical social workers. The Secretary was required to develop criteria for psychologists' services under which psychologists would be required to consult with a patient's attending physician.

Proposal.-- Clinical social workers would be required to consult with a patient's attending physician in the same manner as clinical psychologists.

(c) Reports on Hospital Outpatient Payment

Present law.-- OBRA 87 required the Prospective Payment Assessment Commission (ProPAC) to conduct a study of Medicare payment for hospital outpatient services. Part of the study was to be submitted to Congress by July 1, 1990 and part by March 1, 1991. Section 1135(d)(6) of the Social Security Act also requires the Secretary to report to the Congress on the

development of a prospective method for ambulatory surgery services.

Proposal.-- The provision repeals Section 6137 of OBRA 89 and Section 1135(d)(6) of the Social Security Act.

(d) Radiology and Diagnostic Services Provided in Hospital Outpatient Departments

Present law.-- Payment for outpatient radiology and diagnostic services is limited to a blend of the hospital's costs and physician fee schedule that would apply if the procedure were performed in a physician's office.

Proposal.-- The provision would clarify that outpatient payment limits apply to diagnostic services and that the physician component of the limit is based on the resource based relative value scale.

(e) Payments to Nurse Practitioners in Rural Areas

Present law.-- OBRA 90 provided for direct reimbursement of nurse practitioners and clinical nurse specialists in rural areas. While current law excludes the services of physician assistants, nurse midwives, certified registered nurse anesthetists, and psychologists from the definition of inpatient hospital care, payments for nurse practitioners and clinical nurse specialists were not included in this provision.

Proposal.-- The provision would add the services of nurse practitioners and clinical nurse specialists to the list of services excluded from the definition of inpatient hospital services.

(f) Other Technical and Conforming Amendments.--

Current law.-- Elderly or disabled employees and their spouses who are covered by employer health plans are not required to enroll in the same enrollment period applicable to others. However, they cannot enroll while enrolled in an employer group health plan. Coverage for such individuals begins generally on the first day of the month in which the individual is no longer enrolled in an employer group health plan. The OBRA 90 conferees intended to modify this provision, but statutory language to that effect was omitted from the law.

Proposal.-- The provision would modify the special enrollment period to allow individuals who have employer group health coverage to enroll in Part B at any time they are enrolled in the group health plan, rather than after they leave the plan.

If an individual enrolled in Part B while enrolled in the group health plan or in the first month after leaving the plan, Medicare coverage would begin on the first day of the month in which the individual enrolled (or, at the option of the individual) on the first day of any of the following three months).

(g) Other Minor Technical and Conforming Amendments

Current law.-- Sections 4154 through 4164 of OBRA 90 include a number of minor and technical drafting errors, which are corrected through various technical and conforming amendments.

C. AMENDMENTS TO PARTS A AND B OF THE MEDICARE PROGRAM

1. Home Dialysis Demonstration Project

The provision would correct minor and technical errors contained relating to a demonstration program authorized under OBRA 90.

2. Extension of Secondary Payer Provisions

The provision would correct minor and technical drafting errors relating to Medicare secondary payer requirements in OBRA 90.

3. Health Maintenance Organizations (HMOs)

Present law.-- OBRA 90 required the Secretary to submit a proposal to Congress by January 1, 1992 providing for a more accurate method of paying for HMOs paid on a risk basis. The Secretary was required to publish a proposed rule by March 1, 1992. The Comptroller General was required to review and report to Congress by May 1, 1992 on recommendations to modify the proposed methodology. OBRA 90 also contained a number of minor and technical drafting errors.

Proposal.-- The provision would require the Secretary to revise the payment methodology for HMOs for contract years beginning with 1994. In making revisions, the Secretary would be required to consider (1) the difference in costs associated with beneficiaries with different health status; (2) the effects of using alternative geographic classifications; and (3) the difference in costs associated with beneficiaries for whom Medicare is the secondary payor. The Secretary would be required to submit a proposal to Congress on the revised payment methodology by January 1, 1993. The Secretary would also be required to publish a proposed rule before March 1, 1993 and the Comptroller General would be required to review and report to the Congress by May 1, 1993 on the appropriateness of the proposed rule. By August 31, 1992, the Secretary would be required to publish a final rule for contract years beginning on or after January 1, 1994.

4. Peer Review Organizations (PROs)

Present law.-- OBRA 90 required Peer Review Organizations (PROs) to provide notice to State licensing entities when a physician is found to have furnished services in violation of Section 1154(a) of the Social Security Act. This subsection includes requirements that PROs review the quality of medical care and determine whether certain services are covered by Medicare. As drafted, OBRA 90 requires PROs to notify State boards in the case of a variety of administrative findings, as well as in the case of a problem regarding quality of care.

Proposal.-- PROs would not be required to notify State boards regarding administrative matters, but would continue to be required to notify them in cases of unnecessary or poor quality care. In addition, drafting errors in OBRA 90 would be corrected.

5. Survey and Certification Requirements

Present law.-- The Secretary is prohibited from imposing user fees on facilities for determining compliance with any requirement of Medicare. Current law could be interpreted to mean that user fees imposed pursuant to the Clinical Laboratory Improvement Act (CLIA) are prohibited. In addition, there are minor drafting errors regarding the survey and certification process.

Proposal.-- The law prohibiting user fees would be amended to clarify that CLIA user fees are not subject to the general ban on user fees.

(f) Other Miscellaneous and Technical Amendments

Sections 4201 through 4207 of OBRA 90 contain various minor and technical drafting errors, which are corrected in through minor and technical provisions.

D. AMENDMENTS RELATED TO MEDICARE SUPPLEMENTAL INSURANCE

Present law. -- Section 1882 of the Social Security Act, as most recently amended by the Omnibus Budget Reconciliation Act (OBRA) of 1990, provides for minimum standards for Medicare supplemental insurance (Medigap) policies.

(a) Preventing duplication. The OBRA 1990 amendments strengthen prohibitions against the sale of duplicative coverage to Medicare beneficiaries. The sale of a Medigap policy to an individual already covered under a Medigap policy is prohibited, as is, in general, the sale of a Medigap policy to a Medicaid beneficiary.

Insurers are required to obtain written information from applicants regarding existing health insurance coverage.

The language also appears to prohibit the sale of any health benefits that duplicate any health coverage (including Medicare) to which a Medicare beneficiary is entitled. This might include coverage provided under an employer group health plan, long-term care policies, hospital indemnity polices, and dread disease policies.

(b) Loss ratios and refund of premiums. The OBRA 1990 amendments increased the minimum loss ratio standard for individual Medigap insurance policies from 60 percent to 65 percent. The standard is 75 percent for group policies. Policy issuers are required to provide a refund or credit against future premiums if needed to meet the loss ratio requirements. Loss ratios must be computed and reported in accordance with a uniform methodology specified by the National Association of Insurance Commissioners (NAIC).

(c) Pre-existing condition limitations. The OBRA 1990 amendments prohibit medical underwriting and certain other practices with respect to medicare supplemental insurance policies for which an individual age 65 or older applies during the six month period beginning with the first month during which the individual is first enrolled for benefits under part B.

(d) Other miscellaneous technical corrections. The conference report to accompany OBRA 1990 states the intent of the conferees that the National Association of Insurance Commissioners, in promulgating changes to the Model Medigap Regulations to conform with Federal requirements, would delete from section 12(C) all that follows "unless", which is an exception to limitations on certain sales commissions. The OBRA 1990 amendments also include a number of minor and technical drafting errors.

Proposal. --

(a) Preventing duplication. -- The duplication provision would be clarified to continue to specifically prohibit the sale of a Medigap policy to an individual already covered under a Medigap policy and to prohibit, in general, the sale of a Medigap policy to a Medicaid beneficiary. Prior law would be restored with respect to the sale of other health insurance policies. That is, the sale of any health insurance policy, other than a Medigap policy, would not be considered duplicative if benefits are paid without regard to other health insurance coverage for which the individual is eligible. Other minor and technical drafting errors would be corrected.

(b) Loss ratios and refund of premiums. The provision would clarify that the OBRA 1990 loss ratio standard would apply to

policies sold or renewed after the effective date of the provision. With respect to a refund or credit for policies issued prior to the effective date of the provision, the calculation would be based on aggregate benefits provided and premiums collected for all policies issued by an insurer in a state and based only on aggregate benefits provided and premiums collected under the policies after the effective date. Other minor and technical drafting errors would be corrected.

(c) **Pre-existing condition limitations.** The provision would be clarified to apply to any policy that becomes effective during the six month period beginning with the first month that an individual who is 65 years of age or older is first enrolled for benefits under part B, irrespective of when the policy is issued or whether the application is submitted prior to the beginning of the six month period.

(d) **Other miscellaneous technical corrections.** The statutory language would be clarified to restate the intent of the conferees that certain language be deleted from section 12(C) of the NAIC Model Regulations pertaining to sales commissions. The effective dates for various provisions would be modified so that in general, the effective dates would be the earlier of the date the state adopts standards required in OBRA 1990 or one year after the NAIC promulgates standards in accordance with OBRA 1990 requirements. The NAIC standards were promulgated on July 30, 1991. Other minor and technical drafting errors would be corrected.