DESCRIPTION OF CHAIRMAN'S MARK OF A COMMITTEE AMENDMENT TO THE REVENUE PROVISIONS OF H.R. 3448 (SMALL BUSINESS JOB PROTECTION ACT OF 1996)

Scheduled for Markup

by the

SENATE COMMITTEE ON FINANCE

on June 12, 1996

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's proposed mark of a Committee amendment to the revenue provisions of H.R. 3448 ("Small Business Job Protection Act of 1996"). The Senate Committee on Finance has scheduled a markup of this Committee amendment to the revenue provisions of H.R. 3448 on June 12, 1996. H.R. 3448 was passed by the House on May 22, 1996.

Part I of the document is a description of small business-related tax provisions; Part II is a description of pension simplification provisions; Part III is a description of certain expiring tax provisions; Part IV is a description of revenue offsets; and Part V is a description of technical corrections provisions.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Mark of a Committee Amendment to the Revenue Provisions of H.R. 3448 ("Small Business Job Protection Act of 1996")* (JCX-26-96), June 11, 1996.

I. SMALL BUSINESS AND OTHER TAX PROVISIONS

A. Small Business Provisions

1. Increase in expensing for small businesses

Present Law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $17,500 of the cost of qualifying property placed in service for the taxable year (sec. 179).[2] 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 $17,500 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 increase the $17,500 amount allowed to be expensed under Code section 179 to $25,000. The increase would be phased in as follows:

Taxable year beginning in--	*Maximum expensing*
1997	$18,000
1998	$18,500
1999	$19,000
2000	$20,000
2001	$24,000
2002	$24,000
2003 and thereafter	$25,000

Effective Date

The provision would be effective for property placed in service in taxable years beginning after December 31, 1996, subject to the phase-in schedule set forth above.

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[2] The amount permitted to be expensed under Code section 179 is increased by up to an additional $20,000 for certain property placed in service by a business located in an empowerment zone (sec. 1397A).

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

Present Law

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

Description of Proposal

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

Effective Date

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

3. Tax credit for Social Security taxes paid with respect to employee cash tips

Present Law

Employee tip income is treated as employer-provided wages for purposes of the Federal Insurance Contributions Act ("FICA"). Employees are required to report to the employer the amount of tips received. The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") provided a business tax credit with respect to certain employer FICA taxes paid with respect to tips treated as paid by the employer. The credit applies to tips received from customers in connection with the provision of food or beverages for consumption on the premises of an establishment with respect to which the tipping of employees is customary. OBRA 1993 provided that the FICA tip credit is effective for taxes paid after December 31, 1993. Temporary Treasury regulations provide that the tax credit is available only with respect to tips reported by the employee. The temporary regulations also provide that the credit is effective for FICA taxes paid by an employer after December 31, 1993, with respect to tips received for services performed after December 31, 1993.

Description of Proposal

The proposal would clarify the credit with respect to employer FICA taxes paid on tips by providing that the credit is (1) available whether or not the employee reported the tips on which the employer FICA taxes were paid pursuant to section 6053(a), and (2) effective with respect to taxes paid after December 31, 1993, regardless of when the services with respect to which the tips are received were performed.

The proposal would also modify the credit so that it applies with respect to tips received from customers in connection with the provision of food or beverages, regardless of whether the food or beverages are for consumption on the premises of the establishment.

Effective Date

The clarifications relating to the effective date and nonreported tips would be effective as if included in OBRA 1993. The provision expanding the tip credit to the provision of food or beverages not for consumption on the premises of the establishment would be effective with respect to FICA taxes paid on tips received with respect to services performed after December 31, 1996.

4. Treatment of dues paid to agricultural or horticultural organizations

Present Law

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

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

Description of Proposal

Under the proposal, if an agricultural or horticultural organization described in section 501(c)(5) requires annual dues not exceeding $100 to be paid in order to be a member of such organization, then in no event would any portion of such dues be subject to the UBIT by reason of any benefits or privileges to which members of such organization are entitled. For taxable years beginning after 1995, the $100 amount would be indexed for inflation. The term "dues" would be defined as "any payment required to be made in order to be recognized by the organization as a member of the organization." Thus, if a person is recognized as a member of an organization by virtue of having paid annual dues for his or her membership, then any subsequent payments made by that person during the year to purchase another membership in the same organization would not be within the scope of the provision.

Effective Date

The provision would apply to taxable years beginning after December 31, 1994.[3]

5. Clarify employment tax status of certain fishermen

Present Law

Under present law, service as a crew member on a fishing vessel is generally excluded from the definition of employment for purposes of income tax withholding on wages and for purposes of the Federal Insurance Contributions Act ("FICA") and the Federal Unemployment Tax Act ("FUTA") 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. If a crew member receives any other cash, e.g., payment for services as an engineer, the exemption from FICA and FUTA does not apply. Crew members to which the exemption applies are subject to self-employment taxes.

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[3] Legislative history would indicate the intent that, with respect to dues payments received prior to the effective date of the provision, general UBIT rules under prior law would be applied in a manner consistent with the provision.

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 fewer than 10 individuals. In addition, the exemption would still apply even if the crew member receives certain cash payments. The cash payments could not exceed $100 per trip, would have to be contingent on a minimum catch, and would have to be paid solely for additional duties (e.g., as mate, engineer, or cook) for which additional cash remuneration is customary.

Effective Date

The provision would apply to remuneration paid after December 31, 1994. It would be intended that, with respect to years before the effective date, the Secretary apply the exemption in a manner consistent with the proposal.

6. Modify rules governing issuance of tax-exempt bonds for first-time farmers

Present Law

Interest on bonds issued by States and local governments to finance governmental activities carried out and paid for by those entities is exempt from the regular corporate and individual income taxes. Interest on bonds issued by the governments to provide financing to private persons is taxable unless an exception is provided in the Internal Revenue Code. One such exception allows States and local governments to issue bonds to finance loans to first-time farmers for the acquisition of farm land (and limited amounts of related depreciable farm property) if the purchasers will be the principal user of the property and will materially participate in the farming operation in which the property is to be used.

The amount of financing provided under this exception may not exceed $1 million per farmer (and related parties). The $1 million limit is increased to $10 million if all capital expenditures by the purchaser in the same county (or incorporated municipality) within a prescribed six-year period are aggregated. Aggregate depreciable farm property financing for any purchaser may not exceed $250,000, of which no more than $62,500 may be for used property.

A first-time farmer is defined as an individual who has at no time owned farm land in excess of 15 percent of the median size of a farm in the county in which the land to be financed is located, and the fair market value of the land has not at any time when held by the individual exceeded $125,000.

Under the general rules governing issuance of tax-exempt bonds, bonds for private persons generally may only be issued for acquisition or construction of property (i.e., may not be issued for working capital costs). Use of bond proceeds to finance purchases from related parties is precluded as a working capital financing.

Description of Proposal

The proposal would make two modifications to the rules governing issuance of tax-exempt bonds for first-time farmers. First, the amount of farm land that an individual could own and still be considered a first-time farmer would be doubled, from 15 percent of the median farm size in the county where the land is located to 30 percent.

Second, proceeds of these tax-exempt bonds would be allowed to be used to finance farm purchases by individuals from related parties (e.g., a parent or grandparent), provided that the price paid reflected the fair market value of the property, and that the seller is not involved in the farming operation after the sale (e.g., by materially participating or supplying equipment to be used in the operation).

Effective Date

The provision would be effective for financing provided with bonds issued after the date of enactment.

7. Treatment of newspaper distributors and carriers as direct sellers

Present Law

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

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

In addition to the 20-factor common-law test, there are also some persons who are treated by statute as either employees or independent contractors. For example, "direct sellers" are deemed to be independent contractors. A direct seller is a person engaged in the trade or business of selling consumer products in the home or otherwise than in a permanent retail establishment, if substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person are performed pursuant to a written contract between such person and the service recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes.

The newspaper industry has generally taken the position that newspaper distributors and carriers should be treated as direct sellers for income and employment tax purposes. The Internal Revenue Service has generally taken the position that the direct seller rules do not apply to newspaper distributors and carriers operating under an agency distribution system (i.e., where the publisher retains title to the newspapers).

Description of Proposal

The proposal would treat qualifying newspaper distributors and carriers as direct sellers. Under the proposal, a person engaged in the trade or business of the delivery or distribution of newspapers or shopping news (including any services that are directly related to such trade or business such as solicitation of customers or collection of receipts) would qualify as a direct seller, provided substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person are performed pursuant to a written contract between such person and the service recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes. Consequently, newspaper distributors and carriers operating under an agency distribution system who are paid based on the number of papers delivered and have an appropriate written agreement would be treated as direct sellers. The status of newspaper distributors and carriers who do not qualify as direct sellers under the proposal would continue to be determined under present-law rules.

Effective Date

The provision would be effective with respect to services performed after December 31, 1996.

8. Application of involuntary conversion rules to property damaged as a result of Presidentially declared disasters

Present Law

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period property similar or related in service or use. If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized.

Description of Proposal

Under the proposal, any tangible property acquired and held for productive use in a business would be treated as similar or related in service or use to property that (1) was held for investment or for productive use in a business and (2) was involuntarily converted as a result of a Presidentially declared disaster.

Effective Date

The provision would be effective for disasters for which a Presidential declaration is made after December 31, 1994, in taxable years ending after that date.

9. Treatment of leasehold improvements

Present Law

Depreciation of leasehold improvements

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

Treatment of dispositions of leasehold improvements

A taxpayer generally recovers the adjusted basis of property for purposes of determining gain or loss upon the disposition of the property. Upon the termination of a lease, the adjusted basis of leasehold improvements that were made, but are not retained, by a lessee are taken into account to compute gain or loss by the lessee. The proper treatment of the adjusted basis of improvements made by a lessor upon termination of a lease is less clear. Proposed Treasury regulation section 1.168-2(e)(1) provides that the unadjusted basis of a building's structural components must be recovered as whole. In addition, proposed Treasury regulation sections 1.168-2(l)(1) and 1.168-6(b) provide that "disposition" does not include the retirement of a structural component of real property if there is no disposition of the underlying building. Thus, it appears that it is the position of the Internal Revenue Service that leasehold improvements made by a lessor that constitute structural components of a building must be continued to be depreciated in the same manner as the underlying real property, even if such improvements are retired at the end of the lease term. Some lessors, on the other hand, may be taking the position that a leasehold improvement is a property separate and distinct from the underlying building and that an abandonment loss under section 165 is allowable at the end of the lease term for the adjusted basis of the property. In addition, lessors may argue that even if a leasehold improvement constitutes a structural component of a building, proposed Treasury regulation section 1.168-2(l)(1) (that seemingly denies the deduction at the end of the lease term) applies only to retirements, but not abandonments or demolitions, of such property. Thus, it appears that some lessors take the position that, at least in certain circumstances, the adjusted basis of leasehold improvements may be recovered at the end of the term of the lease to which the improvements relate even if there is no disposition of the underlying building.

Description of Proposal

Under the proposal, a lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessee at the termination of the lease. Thus, the proposal would conform the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease.

For purposes of applying the proposal, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned.

Effective Date

The proposal would be effective for leasehold improvements disposed of after June 12, 1996. No inference would be intended as to the proper treatment of such dispositions before such date.

B. Provisions Relating to S Corporations

1. S corporations permitted to have 75 shareholders

Present Law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders, (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual, (3) a nonresident alien as a shareholder, and (4) more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder.

Description of Proposal

The proposal would increase the maximum number of eligible shareholders from 35 to 75.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

2. Electing small business trusts

Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may not be shareholders in a S corporation. A "qualified subchapter S trust" is a trust which, under its terms, (1) is required to have only one current income beneficiary (for life), (2) any corpus distributed during the life of the beneficiary must be distributed to the beneficiary, (3) the beneficiary's income interest must terminate at the earlier of the beneficiary's death or the termination of the trust, and (4) if the trust terminates during the beneficiary's life, the trust assets must be distributed to the beneficiary. 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 ("electing small business trusts"). In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. A trust must elect to be treated as an electing small business trust.

Each potential current beneficiary of the trust would be counted as a shareholder for purposes of the proposed 75 shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.

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 is taxed at the highest individual rate (currently, 39.6 percent on ordinary income and 28 percent on net capital gain) on this portion of the trust's income. The taxable income attributable to this portion would include (1) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses are allowed only to the extent of capital gains.

In computing the trust's income tax on this portion of the trust, no deduction would be allowed for amounts distributed to beneficiaries, and no deduction or credit is allowed for any item other than the items described above. This income would not be included in the distributable net income of the trust, and thus is not included in the beneficiaries' income. No item relating to the S corporation stock could be apportioned to any beneficiary.

On the termination of all or any portion of an electing small business trust the loss carryovers or excess deductions referred to in section 642(h) would be taken into account by the entire trust, subject to the usual rules on termination of the entire trust.

Treatment of remainder of items held by trust

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust would be disregarded. Although distributions from the trust are deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J, the trust's distributable net income would not include any income attributable to the S corporation stock.

Termination of trust and conforming amendment applicable to all trusts

Where the trust terminates before the end of the S corporation's taxable year, the trust takes into account its pro rata share of S corporation items for its final year. The Proposal would make a conforming amendment applicable to all trusts and estates clarifying that this is the present-law treatment of trusts and estates that terminate before the end of the S corporation's taxable year.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

3. Expansion of post-death qualification for certain trusts

Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may not be shareholders in a S corporation. A grantor trust may remain an S corporation shareholder for 60 days after the death of the grantor. The 60-day period is extended to two years if the entire corpus of the trust is includible in the gross estate of the deemed owner. In addition, a trust may be an S corporation shareholder for 60 days after the transfer of S corporation pursuant to a will.

Description of Proposal

The proposal would expand the post-death holding period to two years for all testamentary trusts.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

4. Financial institutions permitted to hold safe harbor debt

Present Law

A small business corporation eligible to be an S corporation may not have more than one class of stock. Certain debt ("straight debt") is not treated as a second class of stock so long as such debt is an unconditional promise to pay on demand or on a specified date a sum certain in money if: (1) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; (2) there is no convertibility (directly or indirectly) into stock, and (3) the creditor is an individual (other than a nonresident alien), an estate, or certain qualified trusts.

Description of Proposal

The definition of "straight debt" would be expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

5. Rules relating to inadvertent terminations and invalid elections

Present Law

Under present law, if the Internal Revenue Service ("IRS") determines that a corporation's Subchapter S election is inadvertently terminated, the IRS can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Present law does not grant the IRS the ability to waive the effect of an inadvertent invalid Subchapter S election.

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

Description of Proposal

Under the proposal, the authority of the IRS to waive the effect of an inadvertent termination would be extended to allow the IRS 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. The Proposal would also allow the IRS to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely. The IRS may exercise this authority in cases where the taxpayer never filed an election. It is intended that the IRS be reasonable in exercising its authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations and other late or invalid elections.

Effective Date

The provision would apply to taxable years beginning after December 31, 1982.

6. Agreement to terminate year

Present Law

In general, each item of S corporation income, deduction and loss is allocated to shareholders on a per-share, per-day basis. However, if any shareholder terminates his or her interest in an S corporation during a taxable year, the S corporation, with the consent of all its shareholders, may elect to allocate S corporation items by closing its books as of the date of such termination rather than apply the per-share, per-day rule.

Description of Proposal

The proposal would provide that, under regulations to be prescribed by the Secretary of the Treasury, the election to close the books of the S corporation upon the termination of a shareholder's interest is made by all affected shareholders and the corporation, rather than by all shareholders. The closing of the books would apply only to the affected shareholders. For this purpose, "affected shareholders" means any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, "affected shareholders" includes all persons who were shareholders during the year.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

7. Expansion of post-termination transition period

Present Law

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

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

In addition, the audit procedures adopted by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") with respect to partnerships also apply to S corporations. Thus, the tax treatment of items is determined at the corporate, rather than individual level.

Description of Proposal

The present-law definition of post-termination period would be expanded to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss or deduction of the S corporation.. In addition, the definition of "determination" would be expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

In addition, the proposal would repeal the TEFRA audit provisions applicable to S corporations and would provide other rules to require consistency between the returns of the S corporation and its shareholders.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

8. S corporations permitted to hold subsidiaries

Present Law

A small business corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation may not own 80 percent or more of the stock of another corporation (whether an S corporation or a C corporation).

In addition, a small business corporation may not have as a shareholder another corporation (whether an S corporation or a C corporation).

Description of Proposal

An S corporation would be allowed to own 80 percent or more of the stock of a C corporation. The C corporation subsidiary could elect to join in the filing of a consolidated return with its affiliated C corporations. An S corporation would not be allowed to join in such election. Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake would not be treated as passive investment income for purposes of sections 1362 and 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

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

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

9. Treatment of distributions during loss years

Present Law

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

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

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

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

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

10. Treatment of S corporations under subchapter C

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)). In 1988, the Internal Revenue Service took 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.[4] In 1992, the Internal Revenue Service reversed its position, stating that the prior ruling was incorrect.[5]

Description of Proposal

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

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

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

11. Elimination of certain earnings and profits

Present Law

Under present law, the accumulated earnings and profits of a corporation are not

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[4] PLR 8818049, (Feb. 10, 1988).

[5] PLR 9245004, (July 28, 1992)

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 or her income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Description of Proposal

The proposal would provide that if a corporation is an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of that year is reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits would be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his or her share of the taxable income of the S corporation.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

12. Carryover of disallowed losses and deductions under the at-risk rules

Present Law

Under section 1366, the amount of loss an S corporation shareholder may take into account cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the unadjusted basis in any indebtedness of the corporation to the shareholder. Any disallowed loss is carried forward to the next taxable year. Any loss that is disallowed for the last taxable year of the S corporation may be carried forward to the post-termination period. The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, under section 465, a shareholder of an S corporation may not deduct losses that are flowed through from the corporation to the extent the shareholder is not "at-risk" with respect to the loss. Any loss not deductible in one taxable year because of the at-risk rules is carried forward to the next taxable year.

Description of Proposal

Losses of an S corporation that are suspended under the at-risk rules of section 465 would be carried forward to the S corporation's post-termination period.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

13. Adjustments to basis of inherited S stock to reflect certain items of income

Present Law

Income in respect to a decedent ("IRD") generally consists of items of gross income that accrued during the decedent's lifetime but were not includible in the decedent's income before his or her death under his or her 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 such person (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 is often 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 (Treas. reg. sec. 1.742-1). This rule insures that the items of IRD held by a partnership are not later offset by a loss arising from a stepped-up basis. Although S corporation income is taxed to its shareholders in a manner similar to the taxation of a partnership and its partners, no comparable regulation requires a reduction in the basis of stock in an S corporation acquired from a decedent where the S corporation holds items of IRD.

Description of Proposal

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

Effective Date

The provision would apply with respect to decedents dying after the date of enactment.

14. S corporations eligible for rules applicable to real property subdivided for sale by noncorporate taxpayers

Present Law

Under present-law section 1237, a lot or parcel of land held by a taxpayer other than a corporation generally is not treated as ordinary income property solely by reason of the land being subdivided if: (1) such parcel had not previously been held as ordinary income property and if in the year of sale, the taxpayer did not hold other real property; (2) no substantial improvement has been made on the land by the taxpayer, a related party, a lessee, or a government; and (3) the land has been held by the taxpayer for five years.

Description of Proposal

The proposal would allow the present-law capital gains presumption in the case of land held by an S corporation. It is expected that rules similar to the attribution rules for partnerships would apply to S corporation (Treas. reg. sec. 1.1237-1(b)(3)).

Effective Date

The provision would be effective for sales in taxable years beginning after December 31, 1996.

15. Reelecting subchapter S status

Present Law

A small business corporation that terminates its subchapter S election (whether by revocation or otherwise) may not make another election to be an S corporation for five taxable years unless the Secretary of the Treasury consents to such election.

Description of Proposal

For purposes of the five-year rule, any termination of subchapter S status in effect immediately before the date of enactment of the Proposal would not be taken into account. Thus, any small business corporation that had terminated its S corporation election within the five-year period before the date of enactment could re-elect subchapter S status upon enactment of the Proposal without the consent of the Secretary of the Treasury.

Effective Date

The provision would be effective for terminations occurring in a taxable year beginning before January 1, 1997.

16. Financial institutions as eligible corporations

Present Law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which meets certain other requirements. An "ineligible corporation" means any corporation which is a member of an affiliated group, certain financial institutions (i.e., banks, domestic savings and loan associations, mutual savings banks, and certain cooperative banks), certain insurance companies, a section 936 corporation, or a DISC or former DISC.

Description of Proposal

A financial institution would be allowed to be an eligible small business corporation unless such institution uses a reserve method of accounting for bad debts.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

II. PENSION SIMPLIFICATION PROVISIONS

A. Simplified Distribution Rules

Present Law

In general, a distribution of benefits from a tax-favored retirement arrangement (i.e., a qualified plan) generally is includible in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities. A qualified plan includes a qualified pension plan, a qualified annuity plan, and a tax-sheltered annuity contract (sec. 403(b) annuity).

Lump-sum distributions

Lump-sum distributions from qualified plans and annuities are eligible for special 5-year forward averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient first, on account of the death of the employee, second, after the employee attains age 59-1/2, third, on account of the employee's separation from service, or fourth, in the case of self-employed individuals, on account of disability. Lump-sum treatment is not available for distributions from a tax-sheltered annuity.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59-1/2 to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. In general, this election allows the taxpayer to pay a separate tax on the lump-sum distribution that approximates the tax that would be due if the lump-sum distribution were received in 5 equal installments. If the election is made, the taxpayer is entitled to deduct the amount of the lump-sum distribution from gross income. Only one such election on or after age 59-1/2 may be made with respect to any employee.

$5,000 exclusion for employer-provided death benefits

Under present law, the beneficiary or estate of a deceased employee generally can exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employee's death (sec. 101(b)).

Recovery of basis

Amounts received as an annuity under a qualified plan generally are includible in income in the year received, except to the extent they represent the return of the recipient's investment in the contract (i.e., basis). Under present law, a pro-rata basis recovery rule generally applies, so that the portion of any annuity payment that represents nontaxable return of basis is determined by applying an exclusion ratio equal to the employee's total investment in the contract divided by the total expected payments over the term of the annuity.

Under a simplified alternative method provided by the IRS, the taxable portion of qualifying annuity payments is determined under a simplified exclusion ratio method.

In no event can the total amount excluded from income as nontaxable return of basis be greater than the recipient's total investment in the contract.

Required distributions

Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and annuities, IRAs, and tax-sheltered annuities.

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed beginning no later than the participant's required beginning date (sec. 401(a)(9)). The required beginning date is generally April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70-1/2. In the case of a governmental plan or a church plan, the required beginning date is the later of first, such April 1, or second, the April 1 of the year following the year in which the participant retires.

Description of Proposal

Lump-sum distributions

The proposal would repeal 5-year averaging for lump-sum distributions from qualified plans. Thus, the proposal would repeal the separate tax paid on a lump-sum distribution and also would repeal the deduction from gross income for taxpayers who elect to pay the separate tax on a lump-sum distribution. The proposal would preserve the transition rules adopted in the Tax Reform Act of 1986.

$5,000 exclusion for employer-provided death benefits

The proposal would repeal the $5,000 exclusion for employer-provided death benefits.

Recovery of basis

The proposal would provide that basis recovery on payments from qualified plans generally is determined under a method similar to the present-law simplified alternative method provided by the IRS. The portion of each annuity payment that represents a return of basis would be equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under the following table:

Age:	*Number of payments:*
Not more than 55	360
56-60	310
61-65	260
66-70	210
More than 70	160

Required distributions

The proposal would modify the rule that requires all participants in qualified plans to commence distributions by age 70-1/2 without regard to whether the participant is still employed by the employer and generally would replace it with the rule in effect prior to the Tax Reform Act of 1986. Under the proposal, distributions generally would be required to begin by April 1 of the calendar year following the later of first, the calendar year in which the employee attains age 70-1/2 or second, the calendar year in which the employee retires. However, in the case of a 5-percent owner of the employer, distributions would be required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70-1/2.

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70-1/2, the proposal generally would require the employee's accrued benefit to be actuarially increased to take into account the period after age 70-1/2 in which the employee was not receiving benefits under the plan. Thus, under the proposal, the employee's accrued benefit would be required to reflect the value of benefits that the employee would have received if the employee had retired at age 70-1/2 and had begun receiving benefits at that time.

The actuarial adjustment rule and the rule requiring 5-percent owners to begin distributions after attainment of age 70-1/2 would not apply, under the proposal, in the case of a governmental plan or church plan.

Effective Date

Lump-sum distributions

The provision would be effective for taxable years beginning after December 31, 1999.

$5,000 exclusion for employer-provided death benefits

The provision would apply with respect to decedents dying after the date of enactment.

Recovery of basis

The provision would be effective with respect to annuity starting dates beginning 90 days after the date of enactment.

Required distributions

The provision would be effective for years beginning after December 31, 1996. If a participant is currently receiving distributions, but would not have to under the provision, it would be intended that a plan (or annuity contract) could (but would not be required to) permit the participant to stop receiving distributions until such distributions are required under the provision.

B. Increased Access to Retirement Plans

1. Establish SIMPLE retirement plans for small employers

Present Law

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

IRAs are not subject to the same rules as qualified plans, but the amount that can be contributed in any year is significantly less. The maximum deductible IRA contribution for a year is limited to $2,000. Distributions from IRAs and employer-sponsored retirement plans are generally taxable when made. In addition, distributions prior to age 59-1/2 generally are subject to an additional 10-percent early withdrawal tax.

Contributions to an IRA can also be made by an employer at the election of an employee under a salary reduction simplified employee pension ("SARSEP"). Under SARSEPs, which are not qualified plans, employees can elect to have contributions made to the SARSEP or to receive the contributions in cash. The amount the employee elects to have contributed to the SARSEP is not currently includible in income. The annual amount an employee can elect to contribute to a SARSEP is limited to $9,500 for 1996. This dollar limit is indexed for inflation in $500 increments. The election to have amounts contributed to a SARSEP or received in cash is available only if at least 50 percent of the eligible employees of the employer elect to have amounts contributed to the SARSEP. In addition, such election is available for a taxable year only if the employer maintaining the SARSEP had 25 or fewer eligible employees at all times during the prior taxable year. Elective deferrals under SARSEPs are subject to a special nondiscrimination test.

Under one type of qualified plan that can be maintained by an employer, employees can elect to reduce their taxable compensation and have nontaxable contributions made to the plan. Such contributions are called elective deferrals, and the plans which allow such contributions are called qualified cash or deferred arrangements (or "401(k) plans"). Like SARSEPs, the maximum annual amount of elective deferrals that can be made by an individual is $9,500 for 1996. A special nondiscrimination test applies to elective deferrals. An employer may make contributions based on an employee's elective contributions. Such contributions are called matching contributions, and are subject to a special nondiscrimination test similar to the special nondiscrimination test applicable to elective deferrals.

Description of Proposal

In general

The proposal would create a simplified retirement plan for small business called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans could be adopted by employers who employed 100 or fewer employees earning at least $5,000 in compensation for the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan could be either an IRA for each employee or part of a qualified cash or deferred arrangement ("401(k) plan"). If established in IRA form, a SIMPLE plan would not be subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements apply. Within limits, contributions to a SIMPLE plan would not be taxable until withdrawn.

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

SIMPLE retirement plans in IRA form

In general

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

Under the proposal, the employer would be required to satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally would be required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. Under a special rule, the employer could elect a lower percentage matching contribution for all employees (but not less than 1 percent of each employee's compensation). In order for the employer to lower the matching percentage for any year, the employer would have to notify employees of the applicable match within a reasonable time before the 30-day election period for the year (described below). In addition, a lower percentage could not be elected for more than 2 out of any 5 years.

Alternatively, for any year, an employer would be permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation for such year. If such an election were made, the employer would have to notify eligible employees of the change within a reasonable period before the 30-day election period for the year (described below). No contributions other than employee elective contributions and required employer matching contributions (or, alternatively, required employer nonelective contributions) could be made to a SIMPLE account.

Only employers who employed 100 or fewer employees earning at least $5,000 in compensation for the preceding year and who do not currently maintain a qualified plan could establish SIMPLE retirement accounts for their employees. Under a special rule, employers would be given a 2-year grace period to maintain a SIMPLE plan once they are no longer eligible.

Each employee of the employer who received at least $5,000 in compensation from the employer during any 2 prior years and who is reasonably expected to receive at least $5,000 in compensation during the year would have to be eligible to participate in the SIMPLE plan. Nonresident aliens and employees covered under a collective bargaining agreement would not have to be eligible to participate in the SIMPLE plan. Self-employed individuals could participate in a SIMPLE plan.

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

Distributions from a SIMPLE plan generally would be taxed as under the rules relating to IRAs, except that an increased early withdrawal tax (25 percent) would apply to distributions within the first 2 years the employee first participates in the SIMPLE plan.

<u>Tax treatment of SIMPLE accounts, contributions, and distributions</u>

Contributions to a SIMPLE account generally would be deductible by the employer. In the case of matching contributions, the employer would be allowed a deduction for a year only if the contributions are made by the due date (including extensions) for the employer's tax return. Contributions to a SIMPLE account would be excludable from the employee's income. SIMPLE accounts, like IRAs, would not be subject to tax. Distributions from a SIMPLE retirement account generally would be taxed under the rules applicable to IRAs. Thus, they would be includible in income when withdrawn. Tax-free rollovers could be made from one SIMPLE account to another. A SIMPLE account could be rolled over to an IRA on a tax-free basis after a two-year period has expired since the individual first participated in the SIMPLE plan. To the extent an employee is no longer participating in a SIMPLE plan (e.g., the employee has terminated employment), the employee's SIMPLE account would be treated as an IRA.

Early withdrawals from a SIMPLE account generally would be subject to the 10-

percent early withdrawal tax applicable to IRAs. However, withdrawals of contributions during the 2-year period beginning on the date the employee first participated in the SIMPLE plan would be subject to a 25-percent early withdrawal tax (rather than 10 percent).

Employee elective contributions to a SIMPLE account would not be treated as wages for employment tax purposes.

Administrative requirements

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

The proposal would also amend parts 1 and 4, Subtitle B, Title I of ERISA so that only simplified reporting requirements apply to SIMPLE plans and so that the employer will not be subject to fiduciary liability resulting from the employee (or beneficiary) exercising control over the assets in the SIMPLE account. For this purpose, an employee (or beneficiary) would be treated as exercising control over the assets in his or her account upon the earlier of (1) an affirmative election with respect to the initial investment of any contributions, (2) a rollover contribution (including a trustee-to-trustee transfer) to another SIMPLE account or IRA, or (3) one year after the SIMPLE account is established. It would be intended that once an employee (or beneficiary) is treated as exercising control over his or her SIMPLE account, the relief from fiduciary liability would extend to the period prior to when the employee (or beneficiary) was deemed to exercise control.

Reporting requirements

Trustee requirements.--The trustee of a SIMPLE account would be required each year to prepare, and provide to the employer maintaining the SIMPLE plan, a summary description containing the following basic information about the plan: the name and address of the employer and the trustee; the requirements for eligibility; the benefits provided under the plan; the time and method of making salary reduction elections; and the procedures for and effects of, withdrawals (including rollovers) from the SIMPLE account.

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

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

Definitions

For purposes of the rules relating to SIMPLE plans, compensation would be compensation required to be reported by the employer on Form W-2, plus any elective deferrals of the employee. In the case of a self-employed individual, compensation would be net earnings from self-employment. The $150,000 compensation limit (sec. 401(a)(17)) would apply only for purposes of the 2 percent of compensation nonelective contribution formula.[6] "Employer" would include the employer and related employers. Related employers would include trades or businesses under common control (whether incorporated or not), controlled groups of corporations, and affiliated service groups. In addition, the leased employee rules would apply.

For purposes of the rule prohibiting an employer from establishing a SIMPLE plan, if the employer has another qualified plan, an employer would be treated as maintaining a qualified plan if the employer (or a predecessor employer) maintained a qualified plan with respect to which contributions were made, or benefits were accrued, with respect to service for any year in the period beginning with the year the SIMPLE plan became effective and ending with the year for which the determination is being made. A qualified plan would include a qualified retirement plan, a qualified annuity plan, a governmental plan, a tax-sheltered annuity, and a simplified employee pension.

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[6] So, for example, the maximum employer contribution that can be made on behalf of any single eligible employee under the 2 percent of compensation nonelective contribution formula would be $3,000. By contrast, the maximum employer contribution that can be made on behalf of any single eligible employee under the matching contribution formula would be $6,000.

SIMPLE 401(k) plans

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

The safe harbor would be satisfied if, for the year, the employer does not maintain another qualified plan and (1) employee's elective deferrals are limited to no more than $6,000, (2) the employer matches employees' elective deferrals up to 3 percent of compensation (or, alternatively, makes a 2 percent of compensation nonelective contribution on behalf of all eligible employees with at least $5,000 in compensation), and (3) no other contributions are made to the arrangement. Contributions under the safe harbor would have to be 100 percent vested. The employer could not reduce the matching percentage below 3 percent of compensation.

Repeal of SARSEPs

Under the proposal, the present-law rules permitting SARSEPs would no longer apply after December 31, 1996, unless the SARSEP was established before January 1, 1997. Consequently, an employer would not be permitted to establish a SARSEP after December 31, 1996. SARSEPs established before January 1, 1997, could continue to receive contributions under present-law rules, and new employees of the employer hired after December 31, 1996, could participate in the SARSEP in accordance with such rules.

Effective Date

The provisions relating to SIMPLE plans would be effective for years beginning after December 31, 1996.

2. Tax-exempt organizations eligible under section 401(k)

Present Law

Under present law, tax-exempt and State and local government organizations are generally prohibited from establishing qualified cash or deferred arrangements (sec. 401(k) plans). Qualified cash or deferred arrangements (1) of rural cooperatives, (2) adopted by State and local governments before May 6, 1986, or (3) adopted by tax-exempt organizations before July 2, 1986, are not subject to this prohibition.

There is no specific statutory provision governing the Federal income tax liability of Indian tribes.[7] However, the Internal Revenue Service ("IRS") has long taken the position that Indian tribal governments, as well as wholly-owned tribal corporations chartered under Federal law, are not taxable entities and, thus, are immune from Federal income taxes.[8] More recently, the IRS has ruled that any income earned by an unincorporated Indian tribal government or Federally chartered tribal corporation is not subject to Federal income tax, regardless of whether the activities that produced the income are conducted on or off the tribe's reservation.[9]

Description of Proposal

The proposal would allow tax-exempt organizations (including, for this purpose, Indian tribal governments, a subdivision of an Indian tribal government, an agency or instrumentality of an Indian tribal government or subdivision thereof, or a corporation chartered under Federal, State, or tribal law which is owned in whole or in part by any of such entities) to maintain qualified cash or deferred arrangements. The proposal would retain the present-law prohibition against the maintenance of cash or deferred arrangements by State and local governments, except to the extent it may apply to Indian tribal governments.

Effective Date

The provision would be effective for plan years beginning after December 31, 1996. No inference would be intended with respect to whether Indian tribal governments are permitted to maintain qualified cash or deferred arrangements under present law.

3. Spousal IRAs

Present Law

Within limits, an individual is allowed a deduction for contributions to an individual retirement account or an individual retirement annuity (an "IRA"). An

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[7] Section 7871 provides that Indian tribal governments are treated as States for certain limited tax purposes, such as the issuance of certain tax-exempt bonds, certain excise tax exemptions, and for eligibility to receive deductible charitable contributions. Section 7871 also treats Indian tribal governments as States for purposes of the provision that permits State and local government educational organizations to maintain tax-sheltered annuity plans (sec. 403(b)). However, section 7871 does not treat Indian tribal governments as States or State governments for purposes of section 401(k).

[8] See Rev. Rul. 67-284, 1967-2 C.B. 55; Rev. Rul. 81-295, 1981-2 C.B. 15.

[9] See Rev. Rul. 94-16, 1994-12 I.R.B. 1; Rev. Rul. 94-65, 1994-42 I.R.B. 10.

individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA.

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of $2,000 or 100 percent of an individual's compensation (earned income in the case of a self-employed individual). In the case of a married individual whose spouse has no compensation (or elects to be treated as having no compensation), the $2,000 limit on IRA contributions is increased to $2,250.

Description of Proposal

The proposal would modify the present-law rules relating to deductible IRAs by permitting deductible IRA contributions of up to $2,000 to be made for each spouse (including, for example, a home maker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1996.

C. Nondiscrimination Provisions

1. Definition of highly compensated employees and repeal of family aggregation rules

Present Law

Definition of highly compensated employee

An employee, including a self-employed individual, is treated as highly compensated if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer, (2) received more than $100,000 (for 1996) in annual compensation from the employer, (3) received more than $66,000 (for 1996) in annual compensation from the employer and was one of the top-paid 20 percent of employees during the same year, or (4) was an officer of the employer who received compensation in excess of $60,000 (for 1996). If, for any year, no officer has compensation in excess of the threshold, then the highest paid officer of the employer is treated as a highly compensated employee.

Family aggregation rules

A special rule applies with respect to the treatment of family members of certain highly compensated employees for purposes of the nondiscrimination rules applicable to qualified plans. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top-10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit under the plan on behalf of such family member is aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top-10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee. An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouses of a lineal ascendant or descendant of the employee.

Similar family aggregation rules apply with respect to the $150,000 (for 1996) limit on compensation that may be taken into account under a qualified plan (sec. 401(a)(17)) and for deduction purposes (sec. 404(l)). However, under such provisions, only the spouse of the employee and lineal descendants of the employee who have not attained age 19 are taken into account.

Description of Proposal

Definition of highly compensated employee

Under the proposal, an employee would be treated as highly compensated if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year or (2) had compensation for the preceding year in excess of $80,000 (indexed for inflation). The proposal would also repeal the rule requiring the highest paid officer to be treated as a highly compensated employee.

Family aggregation rules

The proposal would repeal the family aggregation rules.

Effective Date

The provisions would be effective for years beginning after December 31, 1996.

2. Modification of additional participation requirements

Present Law

Under present law, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). This requirement may not be satisfied by aggregating comparable plans, but may be applied separately to different lines of business of the employer. A line of business of the employer does not qualify as a separate line of business unless it has at least 50 employees.

Description of Proposal

The proposal would provide that the minimum participation rule applies only to defined benefit pension plans. In addition, the proposal would provide that a defined benefit pension plan does not satisfy the rule unless it benefits no fewer than the lesser of first, 50 employees or second, the greater of (a) 40 percent of all employees of the employer or (b) 2 employees (1 employee if there is only 1 employee).

The proposal also would provide that the requirement that a line of business has at least 50 employees does not apply in determining whether a plan satisfies the minimum participation rule on a separate line of business basis.

Effective Date

The provision would be effective for years beginning after December 31, 1996.

3. Nondiscrimination rules for qualified cash or deferred arrangements and matching contributions

Present Law

Under present law, a special nondiscrimination test applies to qualified cash or deferred arrangements (sec. 401(k) plans). The special nondiscrimination test is satisfied if the actual deferral percentage ("ADP") for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the ADP of all nonhighly compensated employees eligible to defer under the arrangement or (2) the lesser of 200 percent of the ADP of all eligible nonhighly compensated employees or such ADP plus 2 percentage points.

Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are subject to a special nondiscrimination test (the actual contribution percentage ("ACP") test) similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. Employer matching contributions that satisfy certain requirements can be used to satisfy the ADP test, but, to the extent so used, such contributions cannot be considered when calculating the ACP test.

A plan that would otherwise fail to meet the special nondiscrimination test for qualified cash or deferred arrangements is not treated as failing such test if excess contributions (with allocable income) are distributed to the employee or, in accordance with Treasury regulations, recharacterized as after-tax employee contributions. For purposes of this rule, in determining the amount of excess contributions and the employees to whom they are allocated, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentage beginning with those highly compensated employees with the highest actual deferral percentages. A similar rule applies to employer matching contributions.

Description of Proposal

Prior-year data

The proposal would modify the special nondiscrimination tests applicable to elective deferrals and employer matching and after-tax employee contributions to provide that the maximum permitted actual deferral percentage (and actual contribution percentage) for highly compensated employees for the year would be determined by reference to the actual deferral percentage (and actual contribution percentage) for nonhighly compensated employees for the preceding, rather than the current, year. A special rule applies for the first plan year.

Alternatively, under the proposal, an employer would be allowed to elect to use the current year actual deferral percentage (and actual contribution percentage). Such an election could be revoked only as provided by the Secretary.

Safe harbor for cash or deferred arrangements

The proposal would provide that a cash or deferred arrangement satisfies the special nondiscrimination tests if the plan satisfies one of two contribution requirements and satisfies a notice requirement.

A plan would satisfy the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan either first, satisfies a matching contribution requirement or second, the employer makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes elective contributions under the arrangement.

A plan would satisfy the matching contribution requirement if, under the arrangement: first, the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (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 from 3 to 5 percent of compensation; and second, the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees.

Alternatively, if the rate of matching contribution with respect to any rate of elective contribution requirement is not equal to the percentages described in the preceding paragraph, the matching contribution requirement would be deemed to be satisfied if first, the rate of an employer's matching contribution does not increase as an employee's rate of elective contribution increase and second, the aggregate amount of matching contributions at such rate of elective contribution at least equals the aggregate amount of matching contributions that would be made if matching contributions satisfied the above percentage requirements. For example, the alternative test would be satisfied if an employer matches 125 percent of an employee's elective contributions up to the first 3 percent of compensation, 25 percent of elective deferrals from 3 to 4 percent of compensation, and provides no match thereafter. However, the alternative test would not be satisfied if an employer matches 80 percent of an employee's elective contributions up to the first 5 percent of compensation. The former example would satisfy the alternative test because the employer match does not increase and the aggregate amount of matching contributions at any rate of elective contribution is at least equal to the aggregate amount of matching contributions required under the general safe harbor rule.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules would be required to be nonforfeitable and subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)(2)(B) and (C)). It would be intended that employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules could be used to satisfy other qualified retirement plan nondiscrimination rules (except the special nondiscrimination test applicable to employer matching contributions (the ACP test)). So, for example, a cross-tested defined contribution plan that includes a qualified cash or deferred arrangement could consider such employer matching and nonelective contributions in testing.[10]

The notice requirement would be satisfied if each employee eligible to participate in the arrangement is given written notice, within a reasonable period before any year, of the employee's rights and obligations under the arrangement.

Alternative method of satisfying special nondiscrimination test for matching contributions

The proposal would provide a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions (the ACP test). Under this safe harbor, a plan would be treated as meeting the special nondiscrimination test if first, the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and second, the plan satisfies a special limitation on matching contributions.

The limitation on matching contributions would be satisfied if: first, the employer matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6 percent of compensation; second, the rate of an employer's matching contribution does not increase as the rate of an employee's contributions or elective deferrals increase; and third, the matching contribution with respect to any highly compensated employee at any rate of employee contribution or elective deferral is not greater than that with respect to an employee who is not highly compensated.

Any after-tax employee contributions made under the qualified cash or deferred arrangement would continue to be tested under the ACP test. Employer matching and nonelective contributions used to satisfy the safe harbor rules for qualified cash or deferred arrangements could not be considered in calculating such test. However, employer matching and nonelective contributions in excess of the amount required to satisfy the safe

[10] It would be intended that if two plans which include qualified cash or deferred arrangements are treated as one plan for purposes of the nondiscrimination and coverage rules, such qualified cash or deferred arrangements would be treated as one qualified cash or deferred arrangement for purposes of the safe harbor rules. In such a case, unless both qualified cash or deferred arrangements satisfied the safe harbor, both qualified cash or deferred arrangements tested together would have to satisfy the ADP and ACP tests.

harbor rules for qualified cash or deferred arrangements could be taken into account in calculating such test.

Distribution of excess contributions and excess aggregate contributions

The proposal would provide that the total amount of excess contributions (and excess aggregate contributions) is determined as under present law, but the distribution of excess contributions (and excess aggregate contributions) would be required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, excess contributions (and excess aggregate contributions) would be deemed attributable first to those highly compensated employees who have the greatest dollar amount of elective deferrals.

Effective Date

The provisions relating to use of prior-year data and the distribution of excess contributions and excess aggregate contributions would be effective for years beginning after December 31, 1996. The provisions providing for a safe harbor for qualified cash or deferred arrangements and the alternative method of satisfying the special nondiscrimination test for matching contributions would be effective for years beginning after December 31, 1998.

4. Definition of compensation for purposes of the limits on contributions and benefits

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan. For purposes of these limits, present law provides that the definition of compensation generally does not include elective employee contributions to certain employee benefit plans.

Description of Proposal

The proposal would provide that elective deferrals to section 401(k) plans and similar arrangements, elective contributions to nonqualified deferred compensation plans of tax-exempt employers and State and local governments (sec. 457 plans), and salary reduction contributions to a cafeteria plan are considered compensation for purposes of the limits on contributions and benefits.

Effective Date

The provision would be effective for years beginning after December 31, 1997.

D. Miscellaneous Pension Simplification

1. Plans covering self-employed individuals

Present Law

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships and sole proprietors). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. Most, but not all, of this disparity was eliminated by TEFRA. Under present law, certain special aggregation rules apply to plans maintained by owner employees of unincorporated businesses that do not apply to other qualified plans (sec. 401(d)(1) and (2)).

Description of Proposal

The proposal would eliminate the special aggregation rules that apply to plans maintained by self-employed individuals that do not apply to other qualified plans.

Effective Date

The provision would be effective for years beginning after December 31, 1996.

2. Elimination of special vesting rule for multiemployer plans

Present Law

Under present law, except in the case of multiemployer plans, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

In the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100-percent vested no later than upon the participant's completion of 10 years of service. This special rule applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Description of Proposal

The proposal would conform the vesting rules for multiemployer plans to the rules applicable to other qualified plans.

Effective Date

The provision would be effective for plan years beginning on or after the earlier of (1) the later of January 1, 1997, or the date on which the last of the collective bargaining agreements pursuant to which the plan is maintained terminates, or (2) January 1, 1999, with respect to participants with an hour of service after the effective date.

3. Distributions under rural cooperative plans

Present Law

A qualified cash or deferred arrangement can permit withdrawals of employee elective deferrals only after the earlier of (1) the participant's separation from service, death, or disability, (2) termination of the arrangement, or (3) in the case of a profit-sharing or stock bonus plan, the attainment of age 59-1/2 or the occurrence of a hardship of the participant. In the case of a money purchase pension plan, including a rural cooperative plan, withdrawals by participants cannot occur upon attainment of age 59-1/2 or upon hardship.

Description of Proposal

The proposal would provide that a rural cooperative plan that includes a cash or deferred arrangement may permit distributions to plan participants after the attainment of age 59-1/2 or on account of hardship. In addition, the definition of a rural cooperative would be expanded to include certain public utility districts and a national association of rural cooperatives.

Effective Date

The provision would generally be effective for distributions after the date of enactment. The modifications to the definition of a rural cooperative would apply to plan years beginning after December 31, 1996.

4. Treatment of governmental plans under section 415

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan (sec. 415). Certain special rules apply to State and local governmental plans under which such plans may provide benefits greater than those permitted by the limits on benefits applicable to plans maintained by private employers.

In the case of defined benefit pension plans, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $120,000 (indexed for inflation). The dollar limit is reduced in the case of early retirement or if the employee has less than 10 years of plan participation.

Description of Proposal

The proposal would make the following modifications to the limits on contributions and benefits as applied to governmental plans:

(1) the 100 percent of compensation limitation on defined benefit pension plan benefits would not apply; and

(2) the early retirement reduction and the 10-year phase-in of the defined benefit pension plan dollar limit would not apply to certain disability and survivor benefits.

The proposal would also permit State and local government employers to maintain excess benefit plans without regard to the limits on unfunded deferred compensation arrangements of State and local government employers (sec. 457).

Effective Date

The provision would be effective for years beginning after December 31, 1994. No inference would be intended with respect to whether a governmental plan complies with the requirements of section 415 with respect to years beginning before January 1, 1995. With respect to such years, the Secretary would be directed to enforce the requirements of section 415 consistent with the provision.

5. Uniform retirement age

Present Law

A qualified plan generally must provide that payment of benefits under the plan must begin no later than 60 days after the end of the plan year in which the participant reaches age 65. Also, for purpose of the vesting and benefit accrual rules, normal retirement age generally can be no later than age 65. For purposes of applying the limits on contributions and benefits (sec. 415), Social Security retirement age is generally used as retirement age. The Social Security retirement age as used for such purposes is presently age 65, but is scheduled to gradually increase.

Description of Proposal

The proposal would provide that for purposes of the general nondiscrimination rules (sec. 401(a)(4)) the Social Security retirement age (as defined in sec. 415) is a uniform retirement age and that subsidized early retirement benefits and joint and survivor annuities are not treated as not being available to employees on the same terms merely because they are based on an employee's Social Security retirement age (as defined in sec. 415).

Effective Date

The provision would be effective for years beginning after December 31, 1996.

6. Contributions on behalf of disabled employees

Present Law

Under present law, an employer may elect to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. For purposes of the limit on annual additions (sec. 415(c)), the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled. Contributions are not permitted on behalf of disabled employees who were officers, owners, or highly compensated before they became disabled.

Description of Proposal

The proposal would provide that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

Effective Date

The provision would be effective for years beginning after December 31, 1996.

7. Treatment of deferred compensation plans of State and local governments and tax-exempt organizations

Present Law

Under a section 457 plan, an employee who elects to defer the receipt of current compensation is taxed on the amounts deferred when such amounts are paid or made available. The maximum annual deferral under such a plan is the lesser of (1) $7,500 or (2) 33-1/3 percent of compensation (net of the deferral).

Amounts deferred under a section 457 plan may not be made available to an employee before the earlier of (1) the calendar year in which the participant attains age 70-1/2, (2) when the participant is separated from the service with the employer, or (3) when the participant is faced with an unforeseeable emergency.

Benefits under a section 457 plan are not treated as made available if the participant may elect to receive a lump sum payable after separation from service and within 60 days of the election. This exception is available only if the total amount payable to the participant under the plan does not exceed $3,500 and no additional amounts may be deferred under the plan with respect to the participant.

Description of Proposal

The proposal would make three changes to the rules governing section 457 plans.

The proposal would: (1) permit in-service distributions of accounts that do not exceed $3,500 under certain circumstances; (2) increase the number of elections that can be made with respect to the time distributions must begin under the plan, and (3) provide for indexing (in $500 increments) of the dollar limit on deferrals.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1996.

8. Trust requirement for deferred compensation plans of State and local governments

Present Law

Until deferrals under a section 457 plan are made available to a plan participant, such amounts deferred, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights must remain solely the property and rights of the employer, subject only to the claims of the employer's general creditors.

Description of Proposal

Under the proposal, all amounts deferred under a section 457 plan maintained by a State and local governmental employer would have to be held in trust (or custodial account or annuity contract) for the exclusive benefit of employees. The trust (or custodial account or annuity contract) would be provided tax-exempt status. Amounts would not be considered made available to a plan participant merely because they are held in a trust, custodial account, or annuity contract.

Effective Date

The provision generally would be effective with respect to amounts held on or after the date of enactment. In the case of plans in existence on the date of enactment, a trust would not need to be established by reason of the provision until January 1, 1999.

9. Correction of GATT interest and mortality rate provisions in the Retirement Protection Act

Present Law

The Retirement Protection Act of 1994, enacted as part of the implementing legislation for the General Agreement on Tariffs and Trade ("GATT"), modified the actuarial assumptions that must be used in adjusting benefits and limitations. In general, in adjusting a benefit that is payable in a form other than a straight life annuity and in adjusting the dollar limitation if benefits begin before age 62, the interest rate to be used cannot be less than the greater of 5 percent or the rate specified in the plan. Under GATT, if the benefit is payable in a form subject to the requirements of section 417(e)(3), then the interest rate on 30-year Treasury securities is substituted for 5 percent. Also under GATT, for purposes of adjusting any limit or benefit, the mortality table prescribed by the Secretary must be used.

This provision of GATT is generally effective as of the first day of the first limitation year beginning in 1995.

GATT made similar changes to the interest rate and mortality assumptions used to calculate the value of lump-sum distributions for purposes of the rule permitting involuntary dispositions of certain accrued benefits. In the case of a plan adopted and in effect before December 8, 1995, those provisions do not apply before the earlier of (1) the date a plan amendment applying the new assumption is adopted or made effective (whichever is later), or (2) the first day of the first plan year beginning after December 31, 1999.

Description of Proposal

The proposal would conform the effective date of the new interest rate and mortality assumptions that must be used under section 415 to calculate the limits on benefits and contributions to the effective date of the provision relating to the calculation of lump-sum distributions. This rule would apply only in the case of plans that were adopted and in effect before the date of enactment of GATT (December 8, 1994). To the extent plans have already been amended to reflect the new assumptions, plan sponsors would be permitted within 1 year of the date of enactment to amend the plan to reverse retroactively such amendment.[11]

The proposal also would repeal the GATT provision which requires that if the benefit is payable before age 62 in a form subject to the requirements of section 417(e)(3) (e.g., lump sum), then the interest rate to be used to reduce the dollar limit on benefits under section 415 cannot be less than the greater of the rate on 30-year Treasury securities or the rate specified in the plan. Consequently, regardless of the form of benefit, the interest rate to be used could not be less than the greater of 5 percent or the rate specified in the plan.

Effective Date

The provision would be effective as if included in GATT.

10. Multiple salary reduction agreements permitted under section 403(b)

Present Law

Under Treasury regulations, a participant in a tax-sheltered annuity plan (sec. 403(b)) is not permitted to enter into more than one salary reduction agreement in any taxable year. These regulations further provide that a salary reduction agreement is effective only with respect to amounts "earned" after the agreement becomes effective, and that a salary reduction agreement must be irrevocable with respect to amounts earned while the agreement is in effect.

These restrictions do not apply to other elective deferral arrangements such as a qualified cash or deferred arrangement (sec. 401(k)). Under Treasury regulations, participants in a qualified cash or deferred arrangement may enter into more than one salary reduction agreement in a taxable year, such an agreement is effective with respect to

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[11] It would be intended that plan sponsors would have flexibility in adopting the actuarial assumptions required under GATT. For example, plan sponsors would be permitted to apply the actuarial assumptions that must be used for 415 purposes retroactively as provided under GATT. Alternatively, plan sponsors could apply such actuarial assumptions prospectively by either (1) providing a benefit equal to (i) the accrued benefit as of the effective date of the adoption of the new actuarial assumptions determined after applying section 415 using the old actuarial assumptions, plus (ii) the benefit accrued after such effective date determined after applying section 415 using the new actuarial assumptions; or (2) providing a benefit equal to the greater of (i) the accrued benefit as the effective date of the adoption of the new actuarial assumptions determined after applying section 415 using the old actuarial assumptions, or (ii) the entire accrued benefit determined after applying section 415 using the new actuarial assumptions.

compensation currently available to the participant after the agreement becomes effective even though previously "earned," and the agreement may be revoked by the participant.

Description of Proposal

The proposal would provide that for participants in a tax-sheltered annuity plan, the frequency that a salary reduction agreement may be entered into, the compensation to which such agreement applies, and the ability to revoke such agreement shall be determined under the rules applicable to qualified cash or deferred arrangements.

Effective Date

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

11. Application of elective deferral limit to section 403(b) contracts

Present Law

A tax-sheltered annuity plan must provide that elective deferrals made under the plan on behalf of an employee may not exceed the annual limit on elective deferrals ($9,500 for 1996). Plans that do not comply with this requirement may lose their tax-favored status.

Description of Proposal

Under the proposal, each tax-sheltered annuity contract, not the tax-sheltered annuity plan, would have to provide that elective deferrals made under the contract may not exceed the annual limit on elective deferrals. It would be intended that the contract terms be given effect in order for this requirement to be satisfied. Thus, for example, if the annuity contract issuer takes no steps to ensure that deferrals under the contract do not exceed the applicable limit, then the contract would not be treated as satisfying section 403(b). The proposal would be intended to make clear that the exclusion of elective deferrals from gross income by employees who have not exceeded the annual limit on elective deferrals will not be affected to the extent other employees exceed the annual limit. However, if the occurrence of an uncorrected elective deferral made by an employee is attributable to reasonable error, the contract would not fail to satisfy section 403(b), and only the portion of the elective deferral in excess of the annual limit would be includible in gross income.

Effective Date

The provision would be effective for years beginning after December 31, 1995, except that an annuity contract would not be required to meet any change in any requirement by reason of the provision before the 90th day after the date of enactment.

12. Treatment of Indian tribal governments under section 403(b)

Present Law

Under present law, certain tax-exempt employers and certain State and local government educational organizations are permitted to maintain tax-sheltered annuity plans (sec. 403(b)). Indian tribal governments are treated as States for this purpose, so certain educational organizations associated with a tribal government are eligible to maintain tax-sheltered annuity plans.

Description of Proposal

The proposal would provide that any 403(b) annuity contract purchased in a plan year beginning before January 1, 1997, by an Indian tribal government would be treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. The proposal also would provide that such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government.

In addition, beginning January 1, 1997, Indian tribal governments would be permitted to maintain tax-sheltered annuity plans.

Effective Date

The provision would generally be effective on the date of enactment, except that the provision permitting Indian tribal governments to maintain tax-sheltered annuity plans would be effective for taxable years beginning after December 31, 1996.

13. Waiver of minimum waiting period for qualified plan distributions

Present Law

Under present law, in the case of a qualified joint and survivor annuity, a written explanation of the form of benefit must generally be provided to participants no less than 30 days and no more than 90 days before the annuity starting day. Even if a participant has elected to waive the qualified joint and survivor annuity and the spouse has consented to the distribution, the distribution from the plan cannot be made until 30 days after the written explanation was provided to the participant.[12]

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[12] On September 15,1995, Treasury issued temporary regulations (T.D. 8620) which provide that a plan may permit a participant to elect (with any applicable spousal consent) a distribution with an annuity starting date before 30 days have elapsed since the explanation was

Description of Proposal

The proposal would provide that the minimum period between the date the explanation of the qualified joint and survivor annuity is provided and the annuity starting date does not apply if it is waived by the participant and, if applicable, the participant's spouse. For example, if the participant has not elected to waive the qualified joint and survivor annuity, only the participant would need to waive the minimum waiting period.

Effective Date

The provision would be effective with respect to plan years beginning after December 31, 1996.

14. Repeal of combined plan limit

Present Law

Combined plan limit

Present law provides limits on contributions and benefits under qualified retirement plans based on the type of plan (i.e., based on whether the plan is a defined contribution plan or a defined benefit pension plan). An overall limit applies if an individual is a participant in both a defined benefit pension plan and a defined contribution plan (called the combined plan limit).

Excess distribution tax

Present law imposes a 15-percent excise tax on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. Excess distributions are generally the aggregate amount of retirement distributions from such plans during any calendar year in excess of $150,000 (or $750,000 in the case of a lump-sum distribution). An additional 15-percent estate tax is also imposed on an individual's excess retirement accumulation.

Description of Proposal

Combined plan limit

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provided, as long as the distribution commences more than seven days after the explanation was provided. Consequently, even if the participant (and spouse, if applicable) has elected to waive the minimum waiting period for receiving a qualified plan distribution, the distribution from the plan cannot be made until seven days have elapsed since the explanation was provided to the participant.

The proposal would repeal the combined plan limit.

Excess distribution tax

Until the repeal of the combined plan limit is effective, the proposal would suspend the excise tax on excess distributions. The additional estate tax on excess accumulations would continue to apply.

Effective Date

The provision repealing the combined plan limit would be effective with respect to limitation years beginning after December 31, 1999. The provision relating to the excise tax on excess distributions would be effective with respect to distributions received in 1997, 1998, and 1999.

15. Tax on prohibited transactions

Present Law

Present law prohibits certain transactions (prohibited transactions) between a qualified pension plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. A two-tier excise tax is imposed on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction. If the transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed.

Description of Proposal

The proposal would increase the initial-level prohibited transaction tax from 5 percent to 10 percent.

Effective Date

The provision would be effective with respect to prohibited transactions occurring after the date of enactment.

16. Treatment of leased employees

Present Law

An individual (a leased employee) who performs services for another person (the recipient) may be required to be treated as the recipient's employee for various employee benefit provisions, if the services are performed pursuant to an agreement between the recipient and any other person (the leasing organization) who is otherwise treated as the individual's employer (sec. 414(n)). The individual is to be treated as the recipient's employee only if the individual has performed services for the recipient on a substantially full-time basis for a year, and the services are of a type historically performed by employees in the recipient's business field.

An individual who otherwise would be treated as a recipient's leased employee will not be treated as such an employee if the individual participates in a safe harbor plan maintained by the leasing organization meeting certain requirements. Each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe harbor plan, if more than 20 percent of an employer's nonhighly compensated workforce are leased.

Description of Proposal

Under the proposal, the present-law "historically performed" test is replaced with a new test under which an individual is not considered a leased employee unless the individual's services are performed under primary direction or control by the service recipient. As under present law, the determination of whether someone is a leased employee is made after determining whether the individual is a common-law employee of the recipient. Thus, an individual who is not a common-law employee of the service recipient could nevertheless be a leased employee of the service recipient. Similarly, the fact that a person is or is not found to perform services under primary direction or control of the recipient for purposes of the employee leasing rules is not determinative of whether the person is or is not a common-law employee of the recipient.

Whether services are performed by an individual under primary direction or control by the service recipient depends on the facts and circumstances. In general, primary direction and control means that the service recipient exercises the majority of direction and control over the individual. Factors that are relevant in determining whether primary direction or control exists include whether the individual is required to comply with instructions of the service recipient about when, where, and how he or she is to perform the services, whether the services must be performed by a particular person, whether the individual is subject to the supervision of the service recipient, and whether the individual must perform services in the order or sequence set by the service recipient. Factors that generally are not relevant in determining whether such direction or control exists include whether the service recipient has the right to hire or fire the individual and whether the individual works for others.

For example, an individual who works under the direct supervision of the service recipient would be considered to be subject to primary direction or control of the service recipient even if another company hired and trained the individual, had the ultimate (but unexercised) legal right to control the individual, paid his wages, withheld his employment and income taxes, and had the exclusive right to fire him. Thus, for example, temporary secretaries, receptionists, word processing personnel and similar office personnel who are subject to the day-to-day control of the employer in essentially the same manner as a common law employee are treated as leased employees if the period of service threshold is reached.

On the other hand, an individual who is a common-law employee of Company A who performs services for Company B on the business premises of Company B under the supervision of Company A would generally not be considered to be under primary direction or control of Company B. The supervision by Company A must be more than nominal, however, and not merely a mechanism to avoid the literal language of the direction or control test.

An example of the situation in the preceding paragraph might be a work crew that comes into a factory to install, repair, maintain, or modify equipment or machinery at the factory. The work crew includes a supervisor who is an employee of the equipment (or equipment repair) company and who has the authority to direct and control the crew, and who actually does exercise such direction and control. In this situation, the supervisor and his or her crew are required to comply with the safety and environmental precautions of the manufacturer, and the supervisor is in frequent communication with the employees of the manufacturer. As another example, certain professionals (e.g., attorneys, accountants, actuaries, doctors, computer programmers, systems analysts, and engineers) who regularly make use of their own judgement and discretion on matters of importance in the performance of their services and are guided by professional, legal, or industry standards, are not leased employees even though the common law employer does not closely supervise the professional on a continuing basis, and the service recipient requires the services to be performed on site and according to certain stages, techniques, and timetables. In addition to the example above, outside professionals who maintain their own businesses (e.g., attorneys, accountants, actuaries, doctors, computer programmers, systems analysts, and engineers) generally would not be considered to be subject to such primary direction or control.

Under the direction or control test, clerical and similar support staff (e.g., secretaries and nurses in a doctor's office) generally would be considered to be subject to primary direction or control of the service recipient and would be leased employees provided the other requirements of section 414(n) are met.

In many cases, the "historically performed" test is overly broad, and results in the unintended treatment of individuals as leased employees. One of the principal purposes for changing the leased employee rules is to relieve the unnecessary hardship and uncertainty created for employers in these circumstances. However, it is not intended that the direction or control test enable employers to engage in abusive practices. Thus, it is intended that the Secretary interpret and apply the leased employee rules in a manner so as to prevent abuses. This ability to prevent abuses under the leasing rules is in addition to the present-law authority of the Secretary under section 414(o). For example, one potentially abusive situation exists where the benefit arrangements of the service recipient overwhelmingly favor its highly compensated employees, the employer has no or very few nonhighly compensated common-law employees, yet the employer makes substantial use of the services of nonhighly compensated individuals who are not its common-law employees.

Effective Date

The provision would be effective for years beginning after December 31, 1996, except that the provision would not apply to relationships that have been previously determined by an IRS ruling not to involve leased employees. In applying the leased employee rules to years beginning before the effective date, it would be intended that the Secretary use a reasonable interpretation of the statute to apply the leasing rules to prevent abuse.

17. Uniform penalty provisions to apply to certain pension reporting requirements

Present Law

Any person who fails to file an information report with the IRS on or before the prescribed filing date is subject to penalties for each failure. A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments.

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.

Effective Date

The provision would be effective with respect to returns and statements the due date for which is after December 31, 1996.

18. Retirement benefits of ministers not subject to tax on net earnings from self-employment

Present Law

Under present law, certain benefits provided to ministers after they retire are subject to self-employment tax.

Description of Proposal

The proposal would provide that retirement benefits received from a church plan after a minister retires, and the rental value of a parsonage (including utilities) furnished to a minister after retirement, are not subject to self-employment taxes.

Effective Date

The provision would be effective for years beginning before, on, or after December 31, 1994.

19. Treasury to provide model forms for spousal consent and qualified domestic relations orders

Present Law

Present law contains a number of rules designed to provide income to the surviving spouse of a deceased employee. Under these spousal protection rules, defined benefit pension plans and money purchase pension plans are required to provide that vested retirement benefits with a present value in excess of $3,500 are payable in the form of a qualified joint and survivor annuity ("QJSA") or, in the case of a participant who dies before the annuity starting date, a qualified preretirement survivor annuity ("QPSA").

Benefits from a plan subject to the survivor benefit rules may be paid in a form other than a QJSA or QPSA if the participant waives the QJSA or QPSA (or both) and the applicable notice, election, and spousal consent requirements are satisfied.

Present law contains detailed rules regarding the waiver of the QJSA or QPSA forms of benefit and the spousal consent requirements. Generally an election to waive the QJSA or QPSA forms of benefit must be in writing, and, if the participant is married on the annuity starting date, must be accompanied by a written spousal consent acknowledging the effect of such consent and witnessed by a plan representative or notary public. Both the participant's waiver and the spousal consent must state the specific nonspouse beneficiary who will receive the benefit, and, in the case of a QJSA waiver, must specify the particular optional form of benefit that will be paid. The waiver will not be valid unless the participant has previously received a written explanation of (1) the terms and conditions of the QJSA or QPSA forms of benefit, (2) the participant's right to make, and the effect of, an election to waive these forms of benefits, (3) the rights of the participant's spouse, and (4) the right to make, and the effect of, a revocation of an election to waive these forms of benefits.

Also, under present law, benefits under a qualified retirement plan are subject to prohibitions against assignment or alienation of benefits. An exception to this rule generally applies in the case of plan benefits paid to a former spouse pursuant to a qualified domestic relations order ("QDRO").

Description of Proposal

Model spousal consent form

The Secretary would be required to develop a model spousal consent form, no later than January 1, 1997, waiving the QJSA and QPSA forms of benefit. Such form would have to be written in a manner calculated to be understood by the average person, and would have to disclose in plain form whether the waiver is irrevocable or may be revoked by a QDRO.

Model QDRO

The Secretary would be required to develop a model QDRO, no later than January 1, 1997, which satisfies the requirements of a QDRO under present law, and the provisions of which focus attention on the need to consider the treatment of any lump sum payment, QJSA, or QPSA.

Effective Date

The provision would be effective on the date of enactment.

20. Date for adoption of plan amendments

Present Law

Plan amendments to reflect amendments to the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs.

Description of Proposal

The proposal would generally provide that any amendments to a plan or annuity contract required by the pension simplification proposals would not be required to be made before the first plan year beginning on or after January 1, 1997. The date for amendments would be extended to the first plan year beginning on or after January 1, 1999, in the case of a governmental plan.

Effective Date

The provision would be effective on the date of enactment.

III. EXTENSION OF CERTAIN EXPIRING TAX PROVISIONS

1. Work opportunity tax credit

Present Law

General rules.--Prior to January 1, 1995, the targeted jobs tax credit was available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The credit generally was equal to 40 percent of qualified first-year wages. Qualified first-year wages with respect to any individual could not exceed $6,000.

Certification of members of targeted groups.--In general, an individual was not treated as a member of a targeted group unless certification that the individual was a member of such a group was received or requested in writing by the employer from the designated local agency on or before the day on which the individual began work for the employer.

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

(1) Vocational rehabilitation referrals;
(2) Economically disadvantaged youths;
(3) Economically disadvantaged former convicts;
(4) Economically disadvantaged summer youth employees;
(5) Aid to Families with Dependent Children ("AFDC") recipients;
(6) Economically disadvantaged Vietnam-era veterans;
(7) Economically disadvantaged cooperative education students;
(8) SSI recipients; and
(9) General assistance recipients.

Other rules.--No credit was available for wages paid to replacement employees during strikes or lockouts.

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

Length of extension.--Expired January 1, 1995.

Description of Proposal

General rules.--The proposal would replace the targeted jobs tax credit with the "work opportunity tax credit." The work opportunity tax credit would be available on an elective basis for employers hiring individuals from one or more of seven targeted groups. The credit generally would equal to 35 percent of qualified wages.

Certification of members of targeted groups.--In general, an individual would not be treated as a member of a targeted group unless: (1) on or before the day the individual begins work for the employer, the employer received in writing a certification from the designated local agency that the individual is a member of a specific targeted group, or (2) on or before the day the individual is offered work with the employer, a pre-screening notice is completed with respect to that individual and within 14 days after the individual begins work for the employer, the employer submits such notice to the designated local agency as part of a written request for certification. The pre-screening notice would contain the information provided to the employer by the individual that forms the basis of the employer's belief that the individual was a member of a targeted group.

Targeted groups eligible for the credit.--There would be seven groups eligible for the credit:

(1) Vocational rehabilitation referral;
(2) High-risk youth;
(3) Qualified ex-felon;
(4) Qualified summer youth employee;
(5) AFDC or successor program (with special rules for qualified veterans);
(6) Qualified veterans; and
(7) Qualified Food Stamp recipients (18-24 year-olds living in a household receiving food stamps for a period of at least 3 months on the date of hire)

Other rules.--The proposal would retain the prior-law rule denying the credit in the case of strikes or lockouts.

Minimum employment period.--No credit would be allowed for wages paid unless the eligible individual was employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 375 hours (120 hours in the case of a qualified summer youth employee).

Length of extension.--July 1, 1996, through June 30, 1997 (one year).

Effective Date

The credit would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1996, and before July 1, 1997.

2. Employer-provided educational assistance

Present and Prior Law

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

Description of Proposal

The proposal would extend the exclusion for employer-provided educational assistance (including the application of the exclusion to graduate education) for taxable years beginning after December 31, 1994, and before January 1, 1997.

To the extent employers have previously filed Forms W-2 reporting the amount of educational assistance provided as taxable wages, present Treasury regulations would require the employer to file Forms W-2c (i.e., corrected Forms W-2) with the Internal Revenue Service.[13] It would be intended that employers would also be required to provide copies of Form W-2c to affected employees.

The Secretary would be directed to establish expedited procedures for the refund of any overpayment of employment taxes paid on excludable educational assistance provided in 1995 and 1996, including procedures for waiving the requirement that an employer obtain an employee's signature if the employer demonstrates to the satisfaction of the Secretary that any refund collected by the employer on behalf of the employee will be paid to the employee.

Because the exclusion would be extended, no interest and penalties should be imposed if an employer failed to withhold income and employment taxes on excludable educational assistance or failed to report such educational assistance. Further, it would be intended that the Secretary establish expedited procedures for refunding any interest and penalties relating to educational assistance previously paid.

[13] Treasury regulation section 31.6051-1(c).

Effective Date

The provision would be effective with respect to taxable years beginning after December 31, 1994, and before January 1, 1997.

3. Research and experimentation tax credit

Present and Prior Law

General rule

Prior to July 1, 1995, section 41 of the Internal Revenue Code provided for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and does not apply to amounts paid or incurred after June 30, 1995.

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

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[14]

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[14] The Omnibus Budget Reconciliation Act of 1993 included a special rule designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm (i.e., any taxpayer that did not have gross receipts in at least three years during the 1984-1988 period) will be assigned a fixed-base

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, research expenditures and gross receipts of the taxpayer are aggregated with research expenditures and gross receipts of certain related persons for purposes of computing any allowable credit (sec. 41(f)(1)). Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change or ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

Eligible expenditures

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

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control (sec. 41(d)(4)).

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percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled June 30, 1995 expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

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

Description of Proposal

The proposal would extend the research tax credit (including the university basic research credit) for the period July 1, 1996, through June 30, 1997.

The proposal also would expand the definition of "start-up firms" under section 41(c)(3)(B)(I) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.[15]

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

The proposal also would provide for a special rule for payments made to certain nonprofit research consortia. Under this special rule, 75 percent of amounts paid to a research consortium for qualified research would be treated as qualified research expenses eligible for the research credit (rather than 65 percent under the present-law section 41(b)(3) rule governing contract research expenses) if (1) such research consortium is a

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[15] In applying the start-up firm rules, the test would be whether a taxpayer, in fact, both incurred research expenses (which under the present-law rules would be qualified research expenses) and had gross receipts in a particular year, not whether the taxpayer claimed a research tax credit for that year.

tax-exempt organization described in section 501(c)(3) (other than a private foundation) or section 501(c)(6), and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

Effective Date

Extension of the research tax credit would be effective for expenditures paid or incurred during the period July 1, 1996, through June 30, 1997. The modification to the definition of "start-up firms" would be effective for taxable years ending after June 30, 1996. Taxpayers could elect the alternative research credit regime (with lower fixed-base percentages and lower credit rates) for taxable years beginning after June 30, 1996. The rule that treats 75 percent of qualified research consortium payments as qualified research expenses would be effective for taxable years beginning after June 30, 1996.

4. Orphan drug tax credit

Present and Prior Law

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

Under prior law, the orphan drug tax credit could be claimed by a taxpayer only to the extent that its regular tax liability for the year the credit was earned exceeded its tentative minimum tax for that year, after regular tax was reduced by nonrefundable personal credits and the foreign tax credit.[16] Unused credits could not be carried back or carried forward to reduce taxes in other years.

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

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

Description of Proposal

The provision would extend the orphan drug tax credit for the period July 1, 1996, through June 30, 1997.

In addition, the proposal would allow taxpayers to carry back unused credits to three years preceding the year the credit is earned and to carry forward unused credits to 15 years following the year the credit is earned.

Effective Date

Qualified clinical testing expenses incurred during the period July 1, 1996, through June 30, 1997. The provision allowing for the carry back and carry forward of unused credits would be effective for taxable years ending after June 30, 1996.

5. Contributions of appreciated stock to private foundations

Present and Prior Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.[17] However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.[18]

In cases involving contributions to a private foundation (other than certain private

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[17] The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)).

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

operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers were allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to January 1, 1995. Qualified appreciated stock was defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applied only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual was treated as making all contributions that were made by any member of the individual's family. This special rule contained in section 170(e)(5) expired after December 31, 1994.

Description of Proposal

The proposal would extend for the period July 1, 1996, through June 30, 1997, the special rule contained in section 170(e)(5) for contributions of qualified appreciated stock made to private foundations.

Effective Date

The proposal would be effective for contributions of qualified appreciated stock to private foundations made during the period July 1, 1996, through June 30, 1997.

6. Tax credit for producing fuel from a nonconventional source

Present Law

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

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

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

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

Description of Proposal

The binding contract date for facilities producing synthetic fuels from coal and gas from biomass would be extended until the date which is six months after the date of the proposal's enactment, and the placed in service date would be extended for one year. The present sunset on production qualifying for the credit would not be changed. Under the proposal, synthetic fuels from coal and gas from biomass produced from a facility placed in service before January 1, 1998, pursuant to a binding contract entered into before the date which is six months after the date of the proposal's enactment, would be eligible for the tax credit if produced before January 1, 2008.

Effective Date

The provision would be effective upon enactment.

7. Suspend imposition of diesel fuel tax on motorboats

Present Law

Diesel fuel used in recreational motorboats is subject to a 24.4 cents-per-gallon excise tax through December 31, 1999. This tax was enacted by the Omnibus Budget Reconciliation Act of 1993 as a revenue offset for repeal of the excise tax on certain luxury boats.

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

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

Description of Proposal

No tax would be imposed on diesel fuel used in recreational motorboats during the period July 1, 1996, through June 30, 1997.

This exemption would temporarily address current supply problems. In an attempt to find a permanent solution that protects tax collection and avoids supply disruptions, the legislative history accompanying the proposal would request the Treasury Department to study possible alternatives to the current collection regime for motorboat diesel fuel that would provide comparable compliance with the law, and to report to the Committee on Ways and Means and the Committee on Finance no later than April 1, 1997.

Effective Date

The provision would be effective after June 30, 1996.

IV. REVENUE OFFSETS

1. Modifications of the Puerto Rico and possession tax credit

Present Law

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

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

A domestic corporation that has elected the Puerto Rico and possession tax credit and that satisfies these two conditions for a taxable year generally is entitled to a credit based on the U.S. tax attributable to the sum of the taxpayer's possession business income and its QPSII. However, the amount of the credit attributable to possession business income is subject to the limitations enacted by the Omnibus Budget Reconciliation Act of 1993. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed an amount equal to the sum of (i) 60 percent of the taxpayer's qualifying wage and fringe benefit expenses, (ii) specified percentages of the taxpayer's depreciation allowances with respect to qualifying tangible property, and (iii) in certain cases, the taxpayer's qualifying possession income taxes. The credit calculated under the economic activity limit is referred to herein as the "wage credit." In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage is phased down to 50 percent for 1996, 45 percent for 1997, and 40 percent for 1998 and thereafter. The credit calculated under the applicable percentage limit is referred to herein as the "income credit." The amount of the Puerto Rico and possession tax credit attributable to QPSII is not subject to these limitations.

Description of Proposal

In general

The proposal generally would repeal the Puerto Rico and possession tax credit for taxable years beginning after December 31, 1995. However, the proposal would provide special rules under which a corporation that is an existing credit claimant would continue to be eligible to claim credits under the wage credit method. In addition, the proposal would provide grandfather rules under which a corporation that is an existing credit claimant would be eligible to claim credits under the income credit method for a 10-year transition period. Further, a special rule would apply to credits attributable to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands.

For taxable years beginning after December 31, 1995, credits under both the income credit and wage credit methods would apply only to corporations that qualify as existing credit claimants (as defined below). The determination of whether a corporation is an existing credit claimant would be made separately for each possession. A corporation that is an existing credit claimant with respect to such possession would be subject to the limitations described below in determining the credit with respect to operations in such possession for taxable years beginning after December 31, 1995. The credit, subject to such limitations, would be computed separately for each possession with respect to which the corporation is an existing credit claimant.

The Puerto Rico and possession tax credit attributable to QPSII generally would be eliminated for taxable years beginning after December 31, 1995. However, the credit attributable to QPSII would continue to be allowed for QPSII earned before July 1, 1996.

Wage credit

For corporations that are existing credit claimants with respect to a possession and that use the wage credit, the wage credit would be determined in the same manner as under present law for taxable years beginning after December 31, 1995 and before January 1, 2002. For taxable years beginning after December 31, 2001 and before January 1, 2006, the corporation's possession business income that is eligible for the wage credit would be subject to a cap computed as described below. For taxable years beginning in 2006 and thereafter, in computing the economic activity limit on the wage credit, the percentage of the taxpayer's qualifying wage and fringe benefit expenses that is taken into account would be reduced from 60 percent to 40 percent. Moreover, for such years, the corporation's business income that is eligible for the wage credit would continue to be subject to the cap described below.

The proposal would add to the Code a new section which provides a credit determined under the wage credit method for business income from Puerto Rico. Such credit would be computed under the rules described above with respect to the possession tax credit determined under the wage credit method. Such section would apply for taxable years beginning after December 31, 1995.

Income credit

For corporations that are existing credit claimants with respect to a possession and that elected to use the income credit, the income credit would continue to be determined as under present law for taxable years beginning after December 31, 1995 and before January 1, 1998. For taxable years beginning after December 31, 1997 and before January 1, 2006, the corporation's possession business income that is eligible for the income credit would be subject to a cap computed as described below. For taxable years beginning in 2006 and thereafter, the income credit would be eliminated.

A corporation that had elected to use the income credit rather than the wage credit is permitted to revoke that election under present law. Under the proposal, such a revocation would be required to be made not later than with respect to the first taxable year beginning after December 31, 1996; such revocation, if made, would apply to such taxable year and to all subsequent taxable years. Accordingly, a corporation that had an election in effect to use the income credit could revoke such election effective for its taxable year beginning in 1997 and thereafter; such corporation would continue to use the income credit for its taxable year beginning in 1996 and would use the wage credit for its taxable year beginning in 1997 and thereafter.

Computation of income cap

The cap on a corporation's possession business income that is eligible for either the income credit or the wage credit would be computed based on the corporation's possession business income for the base period years ("average adjusted base period possession business income"). Average adjusted base period possession business income would be the average of the adjusted possession business income for each of the corporation's base period years. For the purpose of this computation, the corporation's possession business income for a base period year would be adjusted by an inflation factor that reflects inflation from such year to 1995. In addition, as a proxy for real growth in income throughout the base period, the inflation factor would be increased by 5 percentage points compounded for each year from such year to the corporation's first taxable year beginning on or after October 14, 1995.

The corporation's base period years generally would be three of the corporation's five most recent years ending before October 14, 1995, determined by disregarding the taxable years in which the adjusted possession business incomes were highest and lowest. For purposes of this computation, only years in which the corporation had significant possession business income would be taken into account. A corporation would be considered to have significant possession business income for a taxable year if such income exceeds 2 percent of the corporation's possession business income for the each of the six taxable years ending with the first taxable year ending on or after October 14, 1995. If the corporation has significant possession business income for only four of the five most recent taxable years ending before October 14, 1995, the base period years would be determined by disregarding the year in which the corporation's possession business income was lowest. If the corporation has significant possession business income for three years or fewer of such five years, then the base period years would be all such years. If there is no year of such five taxable years in which the corporation has significant possession business income, then the corporation would be permitted to use as its base period its first taxable year ending on or after October 14, 1995; for this purpose, the amount of possession business income taken into account would be the annualized amount of such income for the portion of the year ended September 30, 1995.

As one alternative, the corporation would be permitted to elect to use its taxable year ending in 1992 as its base period (with the adjusted possession business income for such year constituting its cap). As another alternative, the corporation would be permitted to elect to use as its cap the annualized amount of its possession business income for the first ten months of calendar year 1995, calculated by excluding any extraordinary items (as determined under generally accepted accounting principles) for such period. For this purpose, it is intended that transactions with a related party that are not in the ordinary course of business would be considered to be extraordinary items.

If a corporation's possession business income in a year for which the cap is applicable exceeds the cap, then the corporation's possession business income for purposes of computing its income credit or its wage credit for the year would be an amount equal to the cap. The corporation's income credit would continue to be subject to the applicable percentage limit, with such limit applied based on the corporation's possession business income as reduced to reflect the application of the cap. The corporation's wage credit would be subject to the economic activity limit, with such limit applied based on the corporation's possession business income as reduced to reflect the application of the cap.

<u>Qualification as existing credit claimant</u>

A corporation would be an existing credit claimant with respect to a possession if (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation has elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which is in effect for its taxable year that includes October 13, 1995. A corporation that adds a substantial new line of business after October 13, 1995, would cease to be an existing credit claimant as of the beginning of the taxable year during which such new line of business is added.

For purposes of these rules, a corporation would be treated as engaged in the active conduct of a trade or business within a possession on October 13, 1995, if such corporation was engaged in the active conduct of such trade or business before January 1, 1996, and such corporation had in effect on October 13, 1995, a binding contract for the acquisition of assets to be used in, or the sale of property to be produced in, such trade or business. For example, if a corporation had in effect on October 13, 1995, binding contracts for the lease of a facility and the purchase of machinery to be used in a manufacturing business in a possession and if the corporation began actively conducting that manufacturing business in the possession before January 1, 1996, that corporation would be an existing credit claimant. A change in the ownership of a corporation would not affect its status as an existing credit claimant.

In determining whether a corporation has added a substantial new line of business, it is intended that principles similar to those reflected in Treas. Reg. section 1.7704-2(d) (relating to the transition rules for existing publicly traded partnerships) would apply. For example, a corporation that modifies its current production methods, expands existing facilities, or adds new facilities to support the production of its current product lines and products within the same four-digit Industry Number Standard Industrial Classification Code (Industry SIC Code) would not be considered to have added a substantial new line of business. In this regard, it is intended that the fact that a business which is added is assigned a different four-digit Industry SIC Code than is assigned to an existing business of the corporation would not automatically cause the corporation to be considered to have added a new line of business. For example, a pharmaceutical corporation that begins manufacturing a new drug would not be considered to have added a new line of business. Moreover, a pharmaceutical corporation that begins to manufacture a complete product from the bulk active chemical through the finished dosage form, a process that may be assigned two separate four-digit Industry SIC Codes, would not be considered to have added a new line of business even though it was previously engaged in activities that involved only a portion of the entire manufacturing process from bulk chemicals to finished dosages. It is further intended that, in the case of a merger of affiliated possession corporations that are existing credit claimants, the corporation that survives the merger would not be considered to have added a substantial new line of business by reason of its operation of the existing business of the affiliate that was merged into it.

Special rules for certain possessions

A special rule would apply to the Puerto Rico and possession tax credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. For any taxable year beginning after December 31, 1995, and before January 1, 2006, a corporation that is an existing credit claimant with respect to one of these possessions for such year would continue to determine its Puerto Rico and possession tax credit with respect to operations in such possession as under present law.

For taxable years beginning in 2006 and thereafter, both the Puerto Rico and possession tax credit under the income credit method and the credit attributable to QPSII with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands would be eliminated. For taxable years beginning in 2006 and thereafter, a corporation that is an existing credit claimant with respect to one of these possessions would continue to be entitled to the wage credit with respect to the operations in such possession. However, for such years, in computing the economic activity limit on the wage credit, the percentage of the taxpayer's qualifying wage and fringe benefit expenses that is taken into account would be reduced from 60 percent to 40 percent. Moreover, for such years, the corporation's possession business income attributable to operations in such possession that is eligible for the wage credit would be subject to the cap computed as described above.

Effective Date

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

2. Repeal 50-percent interest income exclusion for financial institution loans to ESOPs

Present Law

A bank, insurance company, regulated investment company, or a corporation actively engaged in the business of lending money may generally exclude from gross income 50 percent of interest received on an ESOP loan (sec. 133). The 50-percent interest exclusion only applies if: (1) immediately after the acquisition of securities with the loan proceeds, the ESOP owns more than 50 percent of the outstanding stock or more than 50 percent of the total value of all outstanding stock of the corporation; (2) the ESOP loan term will not exceed 15 years; and (3) the ESOP provides for full pass-through voting to participants on all allocated shares acquired or transferred in connection with the loan.

Description of Proposal

The proposal would repeal the 50-percent interest exclusion with respect to ESOP loans.

Effective Date

The provision would be effective with respect to loans made after the date of enactment, other than loans made pursuant to a written binding contract in effect before June 10, 1996, and at all times thereafter before such loan is made. The repeal of the 50-percent interest exclusion would not apply to the refinancing of an ESOP loan originally made on or before the date of enactment or pursuant to a binding contract in effect before June 10, 1996, provided: (1) such refinancing loan otherwise meets the requirements of section 133 in effect on or before the date of enactment or June 10, 1996, respectively: (2) the outstanding principal amount of the loan is not increased; and (3) the term of the refinancing loan does not extend beyond the term of the original ESOP loan.

3. Taxation of punitive damages received on account of personal injury or sickness

Present Law

Under present law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness (sec. 104(a)(2)).

The exclusion from gross income of damages received on account of personal injury or sickness specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Courts presently differ as to whether the exclusion applies to punitive damages received in connection with a case involving a physical injury or physical sickness.[19] Certain States provide that, in the case of claims under a wrongful death statute, only punitive damages may be awarded.

Description of Proposal

Under the proposal, the exclusion from gross income would not apply to any punitive damages received on account of personal injury or sickness whether or not related to a physical injury or physical sickness. Under the proposal, present law would continue to apply to punitive damages received in a wrongful death action if the applicable State law (as in effect on September 13, 1995 without regard to subsequent modification) provides, or has been construed to provide by a court decision issued on or before such date, that only punitive damages may be awarded in a wrongful death action. No inference would be intended as to the application of the exclusion to punitive damages prior to the effective date of the bill in connection with a case involving a physical injury or physical sickness.

Effective Date

The provision generally would be effective with respect to amounts received after June 30, 1996. The provision would not apply to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

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[19] The Supreme Court recently agreed to decide whether punitive damages awarded in a physical injury lawsuit are excludable from gross income. O'gilvie v. U.S., 66 F.3d 1550 (10th Cir. 1995), cert. granted, 64 U.S.L.W. 3639 (U.S. March 25, 1996)(No. 95-966). Also, the Tax Court recently held that if punitive damages are not of a compensatory nature, they are not excludable from income, regardless of whether the underlying claim involved a physical injury or physical sickness. Bagley v. Commissioner, 105 T.C. No. 27 (1995).

4. Treatment of financial asset securitization investment trusts ("FASITs")

Present Law

An individual can own income-producing assets directly, or indirectly through an entity (i.e., a corporation, partnership, or trust). Where an individual owns assets through an entity (e.g., a corporation), the nature of the interest in the entity (e.g., stock of a corporation) is different than the nature of the assets held by the entity (e.g., assets of the corporation).

Securitization is the process of converting one type of asset into another and generally involves the use of an entity separate from the underlying assets. In the case of securitization of debt instruments, the instruments created in the securitization typically have different maturities and characteristics than the debt instruments that are securitized.

Entities used in securitization include entities that are subject to tax (e.g., a corporation), conduit entities that generally are not subject to tax (e.g., a partnership, grantor trust, or real estate mortgage investment conduit ("REMIC")), or partial-conduit entities that generally are subject to tax only to the extent income is not distributed to owners (e.g., a trust, real estate investment trust ("REIT"), or regulated investment company ("RIC")).

There is no statutory entity that facilitates the securitization of revolving, non-mortgage debt obligations.

Description of Proposal

In general

The proposal would create a new type of statutory entity called a "financial asset securitization investment trust" ("FASIT") that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally will not be taxable; the FASIT's taxable income or net loss will flow through to the owner of the FASIT.

The ownership interest of a FASIT generally will be required to be entirely held by a single domestic C corporation. It is expected that the Treasury Department will issue guidance on how this rule would apply to cases in which the entity that owns the FASIT joins in the filing of a consolidated return with other members of the group that wish to hold an ownership interest in the FASIT. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and will be subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing yields to maturity over 5 percentage points above the yield to maturity on specified United States government obligations (i.e., "high-yield interests") may be held only by domestic C corporations that are not exempt from income tax.

Qualification as a FASIT

In general

For this purpose, a FASIT would be any entity that: (1) made an election to be treated as a FASIT; (2) has assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called "permitted assets;" (3) has a single ownership interest which is held by an "eligible corporation;" (4) has non-ownership interests (i.e., specified types of debt instruments) called "regular interests;" and (5) is not a RIC.

Election to be a FASIT

Once an election to be a FASIT is made by an entity, the election would apply for that year and all subsequent years until the entity ceases to be a FASIT.[20] Once an entity ceases to be a FASIT, it would not be a FASIT for that year or any subsequent year. Nonetheless, an entity can continue to be a FASIT where the Treasury Department determines that the entity inadvertently ceases to be a FASIT, steps are taken reasonably soon after it is discovered that the entity ceased being a FASIT so that it again qualifies as a FASIT, and the FASIT and its owner take those steps that the Treasury Department deems necessary.

Permitted assets

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

Permitted debt instruments.--A debt instrument would be a "permitted asset" only if the instrument is indebtedness for Federal income tax purposes and it bears (1) fixed interest or (2) variable interest of a type that relates to qualified variable rate debt (as

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[20] See below for a description of the transitional rules that would apply where an existing entity makes an election to be treated as a FASIT.

defined in Treasury regulations prescribed under sec. 860G(a)(1)(B)). Except for cash equivalents, permitted debt obligations cannot be obligations issued, directly or indirectly, by the owner of the FASIT or a related person.

Foreclosure property.--Permitted assets generally would include property (1) acquired on default (or imminent default) of debt instruments held by the FASIT or (2) that would be foreclosure property to a REIT (under sec. 856(e)) or would be foreclosure property to a REIT but for certain leases entered into or construction performed (as described in sec. 856(e)(4)) while held by the FASIT.

Hedges.--Permitted assets would include interest rate or foreign currency notional principal contracts, letters of credit, insurance, guarantees against payment defaults, or other similar instruments as permitted under Treasury regulations, which are reasonably required to guarantee or hedge against the FASIT's risks associated with being the obligor of interests issued by the FASIT.

"Regular interests" of a FASIT

Under the proposal, "regular interests," including "high-yield interests," of a FASIT would be treated as debt for Federal income tax purposes regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a "regular interest," an instrument must have fixed terms and generally must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) a fixed rate, (b) rates that measure contemporaneous variations in the cost of newly borrowed funds, or (c) variable rates allowed to regular interests of a REMIC if the FASIT would otherwise qualify as a REMIC; (3) have a term to maturity of no more than 30 years; (4) have an issued price that does not exceed 125 percent of its stated principal amount; and (5) have a yield to maturity at issue of no more than 5 percentage points above the applicable Federal rate ("AFR") for the calendar month in which the instrument is issued.

A FASIT also may issue high-yield debt instruments, which includes any debt instrument issued by a FASIT that meets the second and third conditions described above, so long as such interests are not held by a disqualified holder. A "disqualified holder" generally is any holder other than (1) a domestic C corporation that does not qualify as a RIC, REIT, REMIC, or cooperative or (2) a dealer who acquires FASIT debt for resale to customers in the ordinary course of business. An excise tax would be imposed at the highest corporate rate on a dealer if there is a change in dealer status or if the holding of the high-yield debt instrument is for investment purposes. A 31-day grace period would be granted before ownership of an interest held by a dealer generally could be treated as held by the FASIT owner for investment purposes.

Permitted ownership holder

A permitted holder of the ownership interest in a FASIT must be an "eligible corporation." For this purpose, an "eligible corporation" generally would be a non-exempt domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

Taxation of a FASIT

In general

A FASIT generally would not be subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the FASIT would be allocable directly to its owner. Any securities held by the FASIT that are treated as held by its owner are treated as held for investment. The taxable income of an owner a FASIT with respect to the FASIT would be calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining OID accrual on debt obligations whose principal is subject to acceleration would apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments. For this purpose, a FASIT's income would not include any income subject to the 100-percent penalty excise tax on prohibited transactions.

Tax on prohibited transactions

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

Taxation of interests in the FASIT

Taxation of holders of regular interests

In general.--A holder of a regular interest, including a high-yield interest, is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder. In addition, section 163(e)(5) would not apply to a regular interest.

High-yield interests.--Holders of high-yield interests would not be allowed to use net operating losses to offset any income derived from the high-yield debt. Any net operating loss carryover shall be computed by disregarding any income arising by reason of the disallowed loss.

In addition, the transferor of a high-yield interest will continue to be taxed on the income from a transferred high-yield interest unless the transferee provides the transferor with an affidavit that the transferee is not a disqualified person or the Treasury Secretary determines that the high-yield interest is no longer held by a disqualified person and a corporate tax has been paid on the income from the high-yield interest while it was held by a disqualified person. High-yield interests may be held without a corporate tax being imposed on the income from the high-yield interest where the interest is held by a dealer in securities who acquired such high-yield interest for sale in the ordinary course of his business as a securities dealer. In such a case, a corporate tax would be imposed on such a dealer if his reason for holding the high-yield interest changes to investment. There would be a presumption that the dealer has not changed his intent for holding high-yield instruments to investment for the first 31 days he holds such interests unless such holding is part of a plan to avoid the restriction on holding of high-yield interests by disqualified persons.

Except as provided by Treasury Regulations, an excise tax would be imposed on a pass-through entity that issues either debt or equity instruments that are supported by regular interests in a FASIT and such instruments bear a yield to maturity (determined under regulations to be issue by the Treasury Department) greater than the yield on the regular interests or the applicable Federal rate plus 5 percentage points if those securities were issued with a view of avoiding the FASIT rules. The tax would be equal the product of the highest corporate rate and the income of any holder of such instrument attributable to the regular interests.

Taxation of holder of ownership interest

All of the FASIT's assets and liabilities would be treated as assets and liabilities of the holder of a FASIT ownership interest and that owner takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest would be the same as its character to the FASIT, except tax-exempt interest would be taken into income of the holder as ordinary income.

Losses on assets contributed to the FASIT would not be allowed upon their contribution, but may be allowed to the FASIT owner upon their disposition by the FASIT.

A special rule would provide that the holder of a FASIT ownership interest cannot offset income from the FASIT ownership interest with any other losses. Any net operating loss carryover of the FASIT owner would be computed by disregarding any income arising by reason of a disallowed loss.

For purposes of the alternative minimum tax, the owner's taxable income would be determined without regard to the minimum FASIT income. The alternative minimum taxable income of the FASIT owner would not be less than the FASIT income for that year, and the alternative minimum tax net operating loss deduction would be computed without regard to the minimum FASIT income.

Transfers to and distributions from FASITs

Gain generally would be recognized immediately by the owner of the FASIT or related person upon the transfer of assets by the FASIT's owner or related person to a FASIT. Any property that is acquired by the FASIT from someone other than its owner or a related person would be treated as if it was acquired by the owner for an amount equal to the asset's its adjusted and then contributed by the owner to the FASIT. In addition, any assets of the FASIT owner or a related person that are used to support FASIT regular interests would be treated as contributed to the FASIT and, thus, also would be treated as sold at the earliest date that such assets support any FASIT's regular interests. To the extent provided by Treasury regulations, gain recognition on the contributed assets may be deferred until such assets support regular interests issued by the FASIT or any indebtedness of the owner or related person. These regulations may adjust other statutory FASIT provisions to the extent such provisions are inconsistent with such regulations. For example, such regulations may disqualify certain assets as permitted assets.

The basis of any FASIT asset would be increased by the amount of the taxable gain recognized on the contribution of the assets to the FASIT.

Valuation rules

In general, except in the case of debt instruments, the value of FASIT assets would be their fair market value. The proposal would provide special rules for valuing debt instruments for purposes of computing gain on the transfer to or from a FASIT. Under these rules, the value of debt instruments that were not acquired on a public market generally would be the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate would be 120 percent of the AFR, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations. For purposes of determining the value of a pool of revolving loan accounts having substantially the same terms, each extension of credit (other than the accrual of interest) would be treated as a separate debt instrument and payments on such extensions having substantially the same terms would be applied assuming that the payments are applied to the earliest credit extensions.

Related person

For purposes of the FASIT rules, a person would be related to another person if that person bears a relationship to the other person specified in sections 267(b) or 707(b)(1), using a 20-percent ownership test instead of the 50-percent test, or such persons are engaged in trades or businesses under common control as determined under sections 52(a) or (b).

Effective Date

The provision would take effect on the date of enactment. If an existing entity (e.g., a trust whose interests are taxed like a partnership) elects to be a FASIT, gain using the special valuation rules (where applicable) would be recognized on all assets held (or treated as held) by the entity on June 11, 1996. However, such gain will be taken into income over a period based on a ratio of the present value of the amortization deductions to the present value of the income inclusions.

5. Extension and phaseout of excise tax on luxury automobiles

Present Law

Present law imposes an excise tax on the sale of automobiles whose price exceeds a designated threshold, currently $34,000. The excise tax is imposed at a rate of 10-percent on the excess of the sales price above the designated threshold. The $34,000 threshold is indexed for inflation.

The tax generally applies only to the first retail sale after manufacture, production, or importation of an automobile. It does not apply to subsequent sales of taxable automobiles.

The tax applies to sales before January 1, 2000.

Description of Proposal

The proposal would extend and phase out the luxury tax on automobiles. The tax rate would be reduced by one percentage point per year beginning in 1996. The tax rate for sales (on or after July 1) in 1996 would be nine percent. The tax rate for sales in 1997 would be eight percent. The tax rate for sales in 1998 would be seven percent. The tax rate for sales in 1999 would be six percent. The tax rate for sales in 2000 would be five percent. The tax rate for sales in 2001 would be four percent. The tax rate for sales in 2002 would be three percent. The tax would expire after December 31, 2002.

Effective Date

The provision would be effective for sales on or after July 1, 1996.

6. Allow certain persons engaged in the local furnishing of electricity or gas to elect not to be eligible for future tax-exempt bond financing

Present Law

Interest on State and local government bonds generally is excluded from income except where the bonds are issued to provide financing for private parties. Present law includes several exceptions, however, that allow tax-exempt bonds to be used to provide financing for certain specifically identified private parties. One such exception allows tax-exempt bonds to be issued to finance facilities for the furnishing of electricity or gas by private parties if the area served by the facilities does not exceed (1) two contiguous counties or (2) a city and a contiguous county (commonly referred to as the "local furnishing" of electricity or gas).

Most private activity tax-exempt bonds are subject to general State private activity bond volume limits of $50 per resident of the State ($150 million, if greater) per year. Tax-exempt bonds for facilities used in the local furnishing electricity or gas are subject to this limit. Like most other private beneficiaries of tax-exempt bonds, borrowers using tax-exempt bonds to finance these facilities are denied interest deductions on the debt underlying the bonds if the facilities cease to be used in qualified local furnishing activities. Additionally, as with all tax-exempt bonds, if the use of facilities financed with the bonds (or the beneficiary of the bonds) changes to a use (or beneficiary) not qualified for tax-exempt financing after the debt is incurred, interest on the bonds becomes taxable unless certain safe harbor standards are satisfied.

Description of Proposal

The proposal would allow owners of facilities that currently qualify as used in the local furnishing of electricity or gas to elect to terminate their qualification for this tax-exempt financing and to expand their service areas without incurring the present-law loss of interest deductions and loss of tax-exemption penalties if --

(1) no additional bonds are issued for the benefit of the person making the election after the date of the proposal's enactment;

(2) the expansion of the person's service area is not financed with any tax-exempt bond proceeds; and

(3) all outstanding tax-exempt bonds of the person making the election are redeemed no later than 6 months after the earliest date on which redemption is not

prohibited under the terms of the bonds, as issued, (or 6 months after the election, if earlier).

The proposal further would limit the exception allowing tax-exempt bonds to be issued for facilities used in the local furnishing of electricity or gas to bonds for facilities (1) of persons that are qualified as engaged in that activity and (1) to the facilities serving areas served by those persons on the date of its enactment.

Effective Date

The proposal would be effective on the date of enactment.

7. Eliminate interest allocation exception for certain nonfinancial corporations

Present Law

For foreign tax credit purposes, taxpayers generally are required to allocate and apportion interest expense between U.S. and foreign source income based on the proportion of the taxpayer's total assets in each location. Such allocation and apportionment is required to be made for affiliated groups (as defined in sec. 864(e)(5)) as a whole rather than on a subsidiary-by-subsidiary basis. However, certain types of financial institutions that are members of an affiliated group are treated as members of a separate affiliated group for purposes of the allocation and apportionment of their interest expense. Section 1215(c)(5) of the Tax Reform Act of 1986 (P.L. 99-514, 100 Stat. 2548) includes a targeted rule which treats a certain corporation as a financial institution for this purpose.

Description of Proposal

The proposal would repeal the targeted rule of section 1215(c)(5) of the Tax Reform Act of 1986.

Effective Date

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

8. Reinstate Airport and Airway Trust Fund excise taxes

Present Law

Before January 1, 1996, five separate excise taxes were imposed to fund the Federal Airport and Airway Trust Fund (the "Trust Fund") program. These aviation excise taxes were --

(1) a 10 percent tax on domestic passenger tickets;

(2) a 6.25 percent tax on domestic freight waybills;

(3) a $6 per-person tax on international departures;

(4) a 17.5 cents-per-gallon tax on jet fuel used in noncommercial aviation; and

(5) a 15 cents-per-gallon tax on gasoline used in noncommercial aviation.[21]

Current trust fund authorizations extend through September 30, 1996.

During the period that these excise taxes were imposed, an exemption was provided for emergency medical helicopters when the helicopters did not take off from or land at Federally assisted airports or otherwise use the Federal air traffic control system.

Description of Proposal

The expired Airport and Airway Trust Fund excise taxes, and transfer of these revenues to the Trust Fund, would be reinstated during the period beginning seven days after enactment and ending after December 31, 1996.

The exemption for certain emergency medical helicopters would be expanded to include fixed-wing aircraft equipped for and exclusively dedicated to acute care emergency medical transportation. Further, this exemption would no longer be limited to flights that do not take off from or land at Federally assisted airports or otherwise use the Federal air traffic control system.

Effective Date

The provision would be effective on the date of enactment. In the case of the domestic passenger ticket and freight waybill taxes, tax would be imposed only on amounts paid after the effective date of the reinstatement.

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

Present and Prior Law

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[21] 14 cents per gallon of this tax continues to be imposed, with the revenues being deposited in the Highway Trust Fund.

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

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

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

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

Description of Proposal

The proposal would restore the contributions in aid of construction provisions that were repealed by the 1986 Act for regulated public utilities that provide water or sewerage disposal services.

Effective Date

The proposal would be effective for amounts received after June 12, 1996.

10. Require water utility property to be depreciated over 25 years

Present Law

Property used by a water utility in the gathering, treatment, and commercial distribution of water and municipal sewers are depreciated over a 20-year period for regular tax purposes. The depreciation method generally applicable to property with a recovery period of 20 years is the 150-percent declining balance method (switching to the straight-line method in the year that maximizes the depreciation deduction). The straight-line method applies to property with a recovery period over 20 years.

Description of Proposal

The proposal would provide that water utility property would have a recovery period of 25 years and would be depreciated under the straight-line method. For this purpose, "water utility property" would mean (1) property that is an integral part of the gathering, treatment, or commercial distribution of water, and that, without regard to the proposal, would have had a recovery period of 20 years and (2) any municipal sewer.

Effective Date

The proposal would be effective for property placed in service on or after June 12, 1996, other than property placed in service pursuant to a binding contract in effect before June 10, 1996, and at all times thereafter before the property is placed in service.

11. Revision of expatriation tax rules

Present Law

Individuals who relinquish U.S. citizenship with a principal purpose of avoiding U.S. taxes are subject to special tax provisions for 10 years after expatriation. The determination of who is a U.S. citizen for tax purposes, and when such citizenship is lost, is governed by the provisions of the Immigration and Nationality Act, 8 U.S.C. section 1401, et. seq.

An individual who relinquishes his U.S. citizenship with a principal purpose of avoiding U.S. taxes is subject to tax on his or her U.S. source income at the rates applicable to U.S. citizens, rather than the rates applicable to other non-resident aliens, for 10 years after expatriation. In addition, the scope of items treated as U.S. source income for this purpose is broader than those items generally considered to be U.S. source income. For example, gains on the sale of personal property located in the United States and gains on the sale or exchange of stock or securities issued by U.S. persons are treated as U.S. source income. This alternative method of income taxation applies only if it results in a higher U.S. tax liability.

Rules applicable in the estate and gift tax contexts expand the categories of items that are subject to the gift and estate taxes in the case of a U.S. citizen who relinquished citizenship with a principal purpose of avoiding U.S. taxes within the 10-year period ending on the date of the transfer. For example, U.S. property held through a foreign corporation controlled by such individual and related persons is included in his or her estate and gifts of U.S.-situs intangible property by such individual are subject to the gift tax.

Description of Proposal

In general

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

Individuals covered

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

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

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

Deemed sale of property upon expatriation

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

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

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

Deferral of payment of tax

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

Interests in trusts

In general

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

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

Nonqualified trusts

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

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

Qualified trusts

If the individual has an interest in a qualified trust, a different set of rules would apply. Under these rules, the amount of unrealized gain allocable to the individual's trust interest would be calculated at the time of expatriation. In determining this amount, all contingencies and discretionary interests would be resolved in the individual's favor (i.e., the individual would be allocated the maximum amount that he or she potentially could receive under the terms of the trust instrument). The expatriation tax imposed on such gains generally would be collected when the individual receives distributions from the trust, or, if earlier, upon the individual's death. Interest would be charged for the period between the date of expatriation and the date on which the tax is paid.

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

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

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

If the individual agrees to waive any treaty rights that would preclude collection of the tax, the tax would be imposed under this provision with respect to distributions from a qualified trust to the individual deducted and withheld from distributions. If the individual does not agree to such a waiver of treaty rights, the tax with respect to distributions to the individual would be imposed on the trust, the trustee would be personally liable therefor, and any other beneficiary of the trust would have a right of contribution against such individual with respect to such tax. Similarly, in the case of the tax imposed in connection with an individual's disposition of a trust interest, the individual's death while holding a trust interest or the individual's holding of an interest in a trust that ceases to be qualified, the tax would be imposed on the trust, the trustee would be personally liable therefor, and any other beneficiary of the trust would have a right of contribution against such individual with respect to such tax.

Election to be treated as a U.S. citizen

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

Date of relinquishment of citizenship

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

Effect on present-law expatriation provisions

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

Treatment of gifts and inheritances from an expatriate

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

Required information reporting and sharing

Under the proposal, an individual who relinquishes citizenship or terminates residency would be required to provide a statement which includes the individual's social security number, forwarding foreign address, new country of residence and citizenship and, in the case of individuals with a net worth of at least $500,000, a balance sheet. In the case of a former citizen, such statement would be due not later than the date the individual's citizenship is treated as relinquished and would be provided to the State Department (or other government entity involved in the administration of such relinquishment). The entity to which the statement would be provided by former citizens would be required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. In the case of a former long-term resident, the statement would be provided to the Secretary of the Treasury with the individual's tax return for the year in which the individual's U.S. residency is terminated. An individual's failure to provide the statement required under this provision would result in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year or (2) $1,000.

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

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

Treasury report

The proposal would direct the Treasury Department to undertake a study on the tax compliance of U.S. citizens and green-card holders residing outside the United States and to make recommendations regarding the improvement of such compliance. The findings of such study and such recommendations would be required to be reported to the House Committee on Ways and Means and the Senate Committee on Finance within 90 days of the date of enactment.

During the course of the 1995 Joint Committee on Taxation staff study on expatriation (see Joint Committee on Taxation, Issues Presented by Proposals to Modify the Tax Treatment of Expatriation (JCS-17-95), June 1, 1995), a specific issue was identified regarding the difficulty in determining when a U.S. citizen has committed an expatriating act with the requisite intent, and thus no longer has the obligation to continue to pay U.S. taxes on his or her worldwide income due to the fact that the individual is no longer a U.S. citizen. Neither the Immigration and Nationality Act nor any other Federal law requires an individual to request a CLN within a specified amount of time after an expatriating act has been committed, even though the expatriating act terminates the status of the individual as a U.S. citizen for all purposes. Accordingly, it is anticipated that the Treasury report, in evaluating whether improved coordination between executive branch agencies could improve compliance with the requirements of the Internal Revenue Code, would review the process through which the State Department determines when citizenship has been lost, and make recommendations regarding changes to such process to recognize the importance of such date for tax purposes. In particular, it is anticipated that the Treasury Department would explore ways of working with the State Department to insure that the State Department will not issue a CLN confirming the commission of an expatriating act with the requisite intent necessary to terminate citizenship in the absence of adequate evidence of both the occurrence of the expatriating act (e.g., the joining of a foreign army) and the existence of the requisite intent.

Effective Date

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

U.S. citizens who committed an expatriating act with the requisite intent to relinquish their U.S. citizenship prior to February 6, 1995, but whose date of relinquishment of citizenship (as determined under the proposal) does not occur until after such date, would be subject to the expatriation tax under the proposal as of date of relinquishment of citizenship. However, the individual would not be subject retroactively to worldwide tax as a U.S. citizen for the period after he or she committed the expatriating act (and therefore ceased being a U.S. citizen for tax purposes under present law). Such an individual would continue to be subject to the expatriation tax imposed by present-law section 877 until the individual's date of relinquishment of citizenship (at which time the individual would be subject to the expatriation tax of the proposal). The rules described in this paragraph would not apply to an individual who committed an expatriating act prior to February 6, 1995, but did not do so with the requisite intent to relinquish his or her U.S. citizenship.

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

V. TECHNICAL CORRECTIONS PROVISIONS

A. Technical Corrections to the Revenue Reconciliation Act of 1990

1. Excise tax provisions

a. Application of the 2.5-cents-per-gallon tax on fuel used in rail transportation to States and local governments

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.

b. Small winery production credit and bonding requirements

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.

2. Other revenue-increase provisions of the 1990 Act

a. Deposits of Railroad Retirement Tax Act taxes

The proposal would conform the Internal Revenue Code to the provision in the Railroad Retirement Solvency Act of 1993 that applies the deposit rules for income taxes withheld from employees' wages and FICA taxes to Railroad Retirement Tax Act taxes.

b. Treatment of salvage and subrogation of property and casualty insurance companies

The proposal would make adjustments to the calculation of a property and casualty insurance company's earnings and profits, so as to equalize the treatment of companies that did, and those that did not, take into account estimated salvage and subrogation recoverable in determining losses incurred prior to 1990.

c. Information with respect to certain foreign-owned or foreign corporations: Suspension of statute of limitations during certain judicial proceedings

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.

d. Rate of interest for large corporate underpayments

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 applicable to certain corporate underpayments.

3. Research credit provision: Effective date for repeal of special proration rule

The proposal would repeal for all taxable years ending after December 31, 1989, the special proration rule for certain qualified research provided for by the 1989 Act.

4. Energy tax provision: Alternative minimum tax adjustment based on energy preferences

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.

The proposal also would provide that the ACE adjustment for taxable years beginning in 1991 and 1992 is to be computed without regard to the special energy deduction.

5. Estate tax freezes

Chapter 14 of the Code contains rules that supersede the willing buyer, willing seller standard for valuation of preferred interest in corporations and partnerships, property held in trust, and term interests in property.

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 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.

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.

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 is treated as a qualified payment unless the transferor elects otherwise. If held by an applicable family member, such stock is not 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.

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. The proposal would treat a transfer to a spouse falling under the annual exclusion the same as a transfer qualifying for the marital deduction. 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. Under the proposal, the election to treat a distribution as giving rise to an inclusion would result in an inclusion only with respect to the payment for which the election is made.

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.

6. Miscellaneous provisions

a. Conforming amendments to the repeal of the General Utilities doctrine

The proposal would make three conforming changes to the Code with respect to the repeal of the General Utilities doctrine. Two of the changes affect section 1248: the first includes a reference to section 355(c)(1) and the second clarifies that, 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 shall be treated as having sold or exchanged the stock for purposes of applying section 1248. The third change repeals section 897(f) as deadwood.

b. Prohibited transaction rules

The proposal would conform the statutory language to legislative intent by providing that transactions that are exempt from the prohibited transaction rules of the Employee Retirement Income Security Act of 1974 ("ERISA") by reason of ERISA section 408(b)(12) are also exempt from the prohibited transaction rules of the Code.

c. Effective date of LIFO adjustment for purposes of computing adjusted current earnings

The proposal would clarify that the calculation of the LIFO adjustment of the adjusted current earnings component of the corporate alternative minimum tax would be effective with respect to adjustments occurring in taxable years beginning after December 31, 1989.

d. Low-income housing tax credit

The proposal would repeal a 1990 technical correction regarding treatment of low-income housing buildings financed with tax-exempt bonds. The proposal would provide, however, that pre-1989 Act law will 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.

7. Expired or obsolete provisions ("deadwood provisions")

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 include (1) a provision that clarifies that solar or wind property owned by a public utility may qualify as 5-year MACRS property (sec. 168(e)(3)(B)(vi)), and (2) a provision that would restore 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)). 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 is intended to change the substance of pre-1990 law.

B. Technical Corrections to the Revenue Reconciliation Act of 1993

1. Treatment of full-time students under the low-income housing credit

The proposal would provide that the full-time student provision is effective on the date of enactment of the Revenue Reconciliation Act of 1993 ("1993 Act").

2. Indexation of threshold applicable to excise tax on luxury automobiles

The proposal would correct the application of the indexing adjustment applicable to the threshold above which the excise tax on luxury automobiles is to apply so that the adjustment calculated for a given calendar year applies for that calendar year rather than in the subsequent calendar year. The provision would be effective on the date of enactment.

3. Indexation of the limitation based on modified adjusted gross income for income from United States savings bonds used to pay higher education tuition and fees

The proposal would correct the indexing of the $60,000 ($40,000 for taxpayers filing as single) threshold to provide that the thresholds be indexed for inflation after 1989.

4. Reporting and notification requirements for lobbying and political expenditures of tax-exempt organizations

Tax-exempt organizations that incur political expenditures are subject to tax under section 527(f). Section 6033(e) requires tax-exempt organizations (other than charities) to (1) report on their annual information returns both the total amount of their lobbying and political expenditures, and the total amount of dues payments allocable to such expenditures, and (2) provide notice to their members of the portion of dues allocable to lobbying and political expenditures (so that such amounts are not deductible to members), or the organization may elect to pay a proxy tax on its lobbying and political expenditures, up to the amount of its dues receipts. The proposal would amend section 6033(e) to clarify that any political expenditures on which tax is paid pursuant to section 527(f) are not subject to the reporting and notification requirements of section 6033(e). In addition, the proposal would clarify that the reporting and notification requirements of section 6033(e) apply to organizations exempt from tax under section 501(a), other than charities described in section 501(c)(3).

5. Estimated tax rules for certain tax-exempt organizations

The proposal would clarify that the Revenue Reconciliation Act of 1993 did not change the method by which a tax-exempt organization annualizes its current year tax liability for purposes of avoiding an underpayment of estimated tax.

6. Current taxation of certain earnings of controlled foreign corporations--application of foreign tax credit limitation

The proposal would clarify that a U.S. shareholder's inclusion of a controlled foreign corporation's earnings invested in excess passive assets is treated like a dividend for purposes of the foreign tax credit limitation.

7. Current taxation of certain earnings of controlled foreign corporations--measurement of accumulated earnings

The proposal would clarify that the accumulated earnings and profits of a controlled foreign corporation taken into account for purposes of determining the foreign corporation's earnings invested in excess passive assets do not include any deficit in accumulated earnings and profits, and do not include current earnings (which are taken into account separately).

8. Current taxation of certain earnings of controlled foreign corporations--aggregation and look-through rules

The proposal would clarify that, within the regulatory authority provided to the Secretary of the Treasury under the 1993 Act, regulations are specifically authorized to coordinate the CFC group treatment and look-through treatment applicable for purposes of determining a foreign corporation's earnings invested in excess passive assets. Pending the promulgation of guidance by the Secretary, it would be intended that taxpayers be permitted to coordinate such treatment using any reasonable method for taking assets into account only once, so long as the method is consistently applied to all controlled foreign corporations (whether or not members of any CFC group) in all taxable years.

9. Treatment of certain leased assets for PFIC purposes

The proposal would clarify that, in the case of any item of property leased by a foreign corporation and treated as an asset actually owned by the foreign corporation in measuring the assets of the foreign corporation for purposes of the PFIC asset test, the amount taken into account with respect to the leased property is the amount determined under the 1993 Act's special measurement rule, which is based on the unamortized portion of the present value of the payments under the lease for the use of the property.

10. Amortization of goodwill and certain other intangibles

The proposal would clarify the antichurning rules of the 1993 Act amortization of intangibles provision. It is clarified that when a taxpayer and its related parties have made an election to apply the 1993 Act to all acquisitions after July 25, 1991, the antichurning rules will not apply when property acquired from an unrelated party after July 25, 1991 (and not subject to the antichurning rules in the hands of the acquirer) is transferred to a taxpayer related to the acquirer after the date of enactment of the 1993 Act.

11. Empowerment zones and eligibility of small farms for tax incentives

The proposal would provide that the $500,000 asset test for determining whether a farm is eligible for section 179 expensing in an empowerment zone and expanded tax-exempt financing benefits in an empowerment zone or enterprise community is applied based on assets of the farm at the end of the current taxable year.

C. Other Tax Technical Corrections

1. Hedge bonds

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.

2. Withholding on distributions from U.S. real property holding companies

The proposal would clarify that withholding requirements under section 1445 apply to any section 301 distribution to a foreign person by a domestic corporation that is or was a U.S. real property holding corporation 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. It is anticipated that withholding certificates would be available to taxpayers that expect to receive section 301 distributions not out of earnings and profits. The provision would be effective for distributions made after the date of enactment.

3. Treatment of credits attributable to working interests in oil and gas properties

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.

The proposal would clarify 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, will 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.

4. Clarification of passive loss disposition rule

The proposal would clarify the rule relating to the computation of the overall loss allowed upon the disposition of a passive activity under the passive loss rules.

5. Estate tax unified credit allowed nonresident aliens under treaty

The proposal would clarify that in determining the pro rata unified credit required by treaty, property exempted by the treaty from U.S. estate tax is not treated as situated in the United States. The provision would be effective on the date of enactment.

6. Limitation on deduction for certain interest paid by corporation to related persons

The proposal would clarify that, under the earnings stripping provision, excess interest carried forward from a year in which the debt-equity ratio threshold is exceeded may 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. The provision would be effective as if included in the amendments made by section 7210(a) of the 1989 Act.

7. Interaction between passive loss activity rules and earnings stripping rules

The proposal would modify section 163(j) of the Code to clarify that the earnings stripping rules apply before the passive loss rules and the at-risk rules. The provision would be effective as if included in the 1989 Act.

8. Branch-level interest tax

The proposal would clarify that 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, such interest is nonetheless 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. These provisions would be effective as if they were made by the Tax Reform Act of 1986 ("1986 Act").

9. Determination of source in case of sales of inventory property

The proposal would clarify that, to the extent that the Secretary of the Treasury had general regulatory authority to provide rules for the sourcing of income from the sales of personal property prior to the 1986 Act, the Secretary of the Treasury retains that authority under present law with respect to inventory property. The provision would be effective as if it were included in the 1986 Act.

10. Repeal of obsolete provisions

The proposal would repeal as obsolete the information reporting requirements of sections 6038 and 6038A relating to section 453C.

11. Clarification of certain stadium bond transition rule in Tax Reform Act of 1986

The proposal would permit the residual interest in the stadium currently held by the City of Cleveland to be assigned to Cuyahoga County, Ohio (the county in which both Cleveland and the stadium are located) because of a change in Ohio State law prior to issuance of the bonds. The proposal would not extend the time for issuing the bonds or otherwise affect the amount of bonds or the location or design of the stadium.

12. Health care continuation rules

The 1989 Act amended the health care continuation rules to provide that if a covered employee is entitled to Medicare and within 18 months of such entitlement separates from service or has a reduction in hours, the duration of continuation coverage for the spouse and dependents is 36 months from the date the covered employee became entitled to Medicare. One possible unintended interpretation of the statutory language, however, would permit continuation coverage for up to 54 months. The proposal would amend the Code (sec. 4980B), title I of the Employee Retirement Income Security Act of 1974 (sec. 602), and the Public Health Service Act (sec. 2202(2)(A)), to limit the continuation coverage in such cases to no more than 36 months. The provision would be effective for plan years beginning after December 31, 1989.

13. Taxation of excess inclusions of a residual interest in a REMIC for taxpayers subject to alternative minimum tax with net operating losses

The proposal would provide the following three rules for determining the alternative minimum taxable income of a taxpayer that is not a thrift institution that holds residual interests in a REMIC: (1) the alternative minimum taxable income of such a taxpayer is computed without regard to the REMIC rule that taxable income cannot be less than the amount of excess inclusions; (2) the alternative minimum taxable income of such a taxpayer for a taxable year cannot be less than the excess inclusions of the residual interests for that year; and (3) the amount of any alternative minimum tax net operating loss deduction of such a taxpayer is computed without regard to any excess inclusions. The provision would be effective for all taxable years beginning after December 31, 1986, unless the taxpayer elects to apply the rules of the proposal only to taxable years beginning after the date of enactment.

14. Application of harbor maintenance tax to Alaska and Hawaii ship passengers

The proposal would clarify that the harbor maintenance tax does not apply to passenger fares where the passengers are transported on U.S. flag vessels operating solely within the State waters of Alaska or Hawaii and adjacent international waters (i.e., leaving and returning to a port in the same State without stopping elsewhere). The provision would be effective as of April 1, 1987 (the effective date of the tax).

15. Modify effective date provision relating to the Energy Policy Act of 1992

The proposal would correct several cross-references in the Energy Policy Act of 1992, and also clarifies the relationship between the basis adjustment rules for the electric vehicle credit (sec. 30(d)(1) and the alternative minimum tax.

16. Treat qualified football coaches plan as multiemployer pension plan for purposes of the Internal Revenue Code

Under the proposal, a correction to the Continuing Appropriations for Fiscal Year 1988 would provide that a qualified football coaches plan (as defined in the Employee Retirement Income Security Act of 1974) is eligible to maintain a qualified cash or deferred arrangement under the Internal Revenue Code on behalf of the football coaches belonging to the American Football Coaches Association. The provision generally would be effective as if included in the Continuing Appropriations for Fiscal Year 1988 (i.e., years beginning after December 22, 1987).

17. Determination of unrecovered investment in annuity contract

In the case of an annuity contract with a refund feature, the proposal would modify the definition of the unrecovered investment in the contract, so that the entire investment in the contract can be recovered tax-free.

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

The proposal would provide for adjustments for inflation, effective for taxable years beginning after December 31, 1995.

19. Treatment of certain veterans' reemployment rights

The proposal would conform the Internal Revenue Code provisions relating to tax-qualified retirement plans to the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), which provides for the rights of reemployed veterans. Thus, under the proposal, the tax-qualified status of a plan would not be affected merely because the plan provides benefits to a reemployed veteran as required or authorized by USERRA. The provision would be effective as of December 12, 1994, the effective date of the benefits-related provisions of USERRA.

20. Reporting of real estate transactions

The proposal would clarify that real estate reporting persons may take into account the cost of complying with the reporting requirements of Code section 6045 in establishing charges for their services, so long as a separately listed charge for such costs is not made.

21. Clarification of denial of deduction for stock redemption expenses

The proposal would clarify that amounts properly allocable to indebtedness on which interest is deductible and properly amortized over the term of that indebtedness are not subject to the provision of section 162(k) denying a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock. This clarification would be effective as if included in the 1986 Act.

In addition, the proposal would clarify that the rules of section 162(k) apply to any acquisition of its stock by a corporation or by a party that has a relationship to the corporation described in section 465(b)(3)(C)(which applies a more than 10-percent relationship test in certain cases). These clarifications would apply to amounts paid or incurred after September 13, 1995.

22. Definition of passive income in determining passive foreign investment company status

The proposal would clarify that foreign trade income of a foreign sales corporation and export trade income of an export trade corporation do not constitute passive income for purposes of the passive foreign investment company definition. The provision would be effective as if it were included in the Tax Reform Act of 1986.

23. Exclusion from income for combat zone compensation

The proposal would change obsolete references to "combat pay" to references to "combat zone compensation."

24. Certain property not treated as section 179 property

The proposal would restore pre-1990 law to deny the section 179 expensing allowance for the following property: (1) property described in section 50(b) (generally, property used outside the U.S., property used in connection with furnishing lodging, property used by tax-exempt organizations, and property used by governments and foreign persons); and (2) air conditioning or heating units. As under present law, the section 179 expensing allowance would continue to be available for horses.

25. Expiration date of special ethanol blender refund

Ethanol used as a taxable motor fuel receives tax subsidies which are claimed as an income tax credit, or alternatively as an excise tax reduction (when ethanol is blended with gasoline into "gasohol"). The benefit may be claimed against excise tax liability in either of two ways: (1) by purchasing gasoline destined for blending with ethanol at a reduced excise tax rate, or (2) before October 1, 1995, by claiming expedited refunds of excise tax paid on gasoline purchased at the full 18.4-cents-per-gallon rate after that gasoline is blended with ethanol. In general, the gasoline (including gasohol) excise tax provisions associated with the Highway Trust Fund expire after September 30, 1999. The proposal would correct a 1990 drafting error by conforming the expiration date for the excise tax expedited refund provision for gasohol blenders to that for gasoline tax provisions generally.