DESCRIPTION OF TAX PROVISIONS INCLUDED IN A PLAN TO ACHIEVE A BALANCED BUDGET SUBMITTED TO THE CONGRESS BY THE PRESIDENT ON JANUARY 6, 1996

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of the

JOINT COMMITTEE ON TAXATION

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CONTENTS

Page

INTRODUCTION 1

I. MIDDLE-CLASS BILL OF RIGHTS 2

A. Middle-Class Tax Relief 2

1. Credit for families with young children 2

2. Deduction for higher education expenses 5

B. Provisions Relating to Individual Retirement Plans 9

C. Increase in Deduction for Health Insurance Expenses of Self-Employed Individuals 14

II. LIMITATIONS ON CORPORATE AND OTHER TAX PROVISIONS . 15

A. Expatriation Tax Provisions 15

B. Corporate Tax Reforms 24

1. Require gain recognition for certain extraordinary dividends 24

2. Registration of confidential corporate tax shelters 25

3. Disallow interest deduction for corporate-owned life insurance policy loans 27

4. Phase out preferential treatment for certain large farm corporations required to use accrual accounting 30

5. Modification of Puerto Rico and possessions tax credit (sec. 936) 32

6. Restrict like-kind exchange rules for certain personal property 33

7. Repeal of financial institution transition rule to interest allocation rules 34

8. Conversion of large corporations into S corporations treated as complete liquidation (sec. 1374) 35

Page

9. Modification of taxable years to which net operating losses may be carried 37

10. Constructive sales treatment for appreciated financial positions 37

11. Disallowance of interest on indebtedness allocable to tax-exempt obligations 39

12. Limit dividends received deduction 42

a. Reduce dividends received deduction to 50 percent 42

b. Modify holding period for dividends received deduction 42

13. Treat certain preferred stock as "boot" 43

14. Deny interest deduction on certain debt instruments 45

15. Defer interest deduction on certain convertible debt 47

C. Foreign Tax Provisions 49

1. Modifications of rules relating to foreign trusts having one or more United States beneficiaries 49

2. Expand subpart F provisions regarding income from notional principal contracts and stock lending transactions 64

3. Treatment of foreign oil and gas extraction income 65

4. Repeal of exclusion of earned income of citizens or residents of the United States living abroad 67

D. Accounting Provisions 68

1. Treatment of bad debt deductions of thrift institutions 68

2. Reform depreciation under the income forecast method 71

3. Repeal lower-of-cost-or-market method of accounting for inventory . . 74

Page

E. Administrative Provisions 76

1. Repeal advance refunds of diesel fuel tax to purchasers of diesel-powered automobiles, vans, and light trucks 76

2. Increase penalties for failure to file correct information returns 76

F. Casualty and Involuntary Conversion Provision (sec. 1033) 79

1. Basis adjustment to property held by corporation where stock in corporation is replacement property under involuntary conversion rules 79

G. Excise Tax on Amounts of Private Excess Benefits 81

H. Extension of Certain Taxes 90

1. Reinstate Superfund excise taxes and corporate environmental income tax 90

2. Reinstate Oil Spill Liability Trust Fund excise tax 91

3. Extension of Federal unemployment tax 91

I. Certain Individual Income Tax Provisions 93

1. Disallow rollover under section 1034 to the extent of previously claimed depreciation for home office or other depreciable use of residence 93

2. Extension of withholding to certain gambling winnings 94

3. Require taxpayers to include rental value of residence in income without regard to period of rental 95

J. Earned Income Credit Provisions 96

1. Deny credit to individuals not authorized to be employed in the United States 96

2. Change definition of disqualified income 98

Page

3. Provide advance payment of the credit through State demonstration programs 99

K. Other Revenue Provisions 102

1. Certain Federal assistance includible in income 102

2. Dependent care credit to be refundable; phaseout of credit 102

3. Federal income tax refund offset 103

4. IRS collection of child and spousal support arrears 103

5. Apply mathematical or clerical error procedures for dependency exemptions and filing status when correct taxpayer identification numbers are not provided 104

6. Notice of availability of earned income and dependent care credits to be included on W-4 form 105

APPENDIX: ESTIMATED BUDGET EFFECTS OF THE "MIDDLE CLASS BILL OF RIGHTS TAX RELIEF ACT OF 1996" 106

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the tax-related provisions contained in the President's message submitted to the Congress on January 6, 1996. On January 6, 1996, the President submitted a plan to the Congress to achieve a balanced budget not later than the fiscal year 2002 as certified by the Congressional Budget Office. This plan was prepared by Senator Daschle and if passed in its current form by the Congress, the President stated that he would sign it into law.[2]

For each of the tax-related provisions in the President's message, this document provides a description of present law, the proposal, the effective date, and any recent related legislative background. The descriptions do not in all cases reflect the statutory language of the plan, as submitted to Congress on January 6, 1996. For example, the January 6, 1996 document contained certain elements of the Taxpayer Bill of Rights 2 and a provision relating to certain disclosure of tax return information for the administration of certain veterans programs which the Joint Committee staff believes to have been included in the statutory language in error. For this reason, no description of these provisions is included in this document.

Part I of the document describes the "Middle-Class Bill of Rights" provisions. Part II describes the corporate and other tax provisions in the budget proposal. The Appendix shows the estimated budget effects of the tax provisions for fiscal years 1996-2002.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Tax Provisions Included in a Plan to Achieve a Balanced Budget Submitted to the Congress By the President on January 6, 1996* (JCX-1-96), January 24, 1996.

[2] See Message from the President of the United States, *Deficit Reduction and Balanced Budget by Fiscal Year 2002*, House Doc. 104-160, January 9, 1996. Many of these tax provisions were included in the President's seven-year balanced budget proposal released on December 7, 1995. (For a description of the President's December 7, 1995 tax proposals, see Joint Committee on Taxation, *Description of the Tax and Health Insurance Reform Provisions in the President's Seven-Year Balanced Budget Proposal released on December 7, 1995* (JCX-58-95), December 15, 1995.)

I. MIDDLE CLASS BILL OF RIGHTS

A. Middle Class Tax Relief

1. Credit for families with young children

Present Law

In general

Present law does not provide tax credits based solely on the taxpayer's number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is $2,550 for 1996, and is adjusted annually for inflation. In 1996, the amount of the personal exemption is phased out for taxpayers with AGI in excess of $117,950 for single taxpayers, $147,450 for heads of household, and $176,950 for married couples filing joint returns. These phaseout thresholds are adjusted annually for inflation.

In addition, eligible low-income workers are able to claim a refundable earned income tax credit. The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the phaseout threshold, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. For taxpayers with earned income (or AGI, if greater) in excess of the phaseout limit, no credit is allowed.

Mathematical or clerical errors

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

assessment is satisfied, however, the taxpayer may file a claim for refund if he or she believes the assessment was made in error.

Description of Proposal

The proposal would provide taxpayers with an income tax credit of $300 for each qualifying child under the age of 13 (as of the close of the calendar year in which the taxpayer's taxable year begins) for taxable years 1996, 1997 and 1998. The amount of the credit would be increased to $500 for each qualifying child for taxable years beginning after December 31, 1998. The credit would not apply to taxable years beginning after December 31, 2000.

The credit would be phased out ratably for taxpayers with AGI over $60,000 and would be fully phased out at AGI of $75,000. In the case of a taxable year beginning after calendar year 1999, the maximum credit and the beginning point of the phaseout range would be indexed annually for inflation. For each year in which the maximum amount of the credit exceeds $500, the size of the phaseout range would be increased from $15,000 (i.e., $75,000 minus $60,000) to 30 times the maximum amount of the credit in that year. For purposes of all these AGI tests, the taxpayer's AGI would be increased by any amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, the Northern Mariana Islands, and American Samoa; and residents of Puerto Rico, respectively).

To be a qualifying child, an individual would have to satisfy a relationship test, a dependency test, and an identification test. An individual would satisfy the relationship test if the individual is a son or daughter of the taxpayer, a stepson or stepdaughter of the taxpayer, or an adopted child of the taxpayer. An adopted child would include a child who is legally adopted or who is placed with the taxpayer by an authorized placement agency for adoption by the taxpayer. A foster child also would satisfy the relationship test if, for the taxpayer's entire taxable year, the foster child (1) is a member of the taxpayer's household and (2) has as his principal place of abode the home of the taxpayer.

An individual would satisfy the dependency test if the individual is a dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency deduction.

An individual would satisfy the identification test if the individual's taxpayer identification number is included on the taxpayer's return for such taxable year. Rules similar to those made applicable by the Administration proposals to the earned income tax credit would apply. If a taxpayer fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error and thus any notification that the taxpayer owes additional tax because of that omission would not be treated as a notice of deficiency.

The maximum amount of the credit for each taxable year could not exceed an amount equal to the sum of: (1) the taxpayer's regular income tax liability (net of applicable credits) less

(2) the sum of the taxpayer's tentative minimum tax liability and earned income tax credit allowed.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995, and before January 1, 2001.

Legislative Background

President's December budget proposal

A provision in the President's seven-year balanced budget proposal released on December 7, 1995, was identical, except that the credit would not sunset after 2000.

H.R. 980 and S. 452

A provision was included in the President's fiscal year 1996 budget proposal (the "Middle-Class Bill of Rights Tax Relief Act of 1995," introduced on February 16, 1995, as H.R. 980 by Representatives Gephardt and Gibbons and as S. 452 by Senators Moynihan and Daschle) that was identical, except that the credit would not sunset after 2000.

H.R. 2491

The Balanced Budget Act of 1995 (H.R. 2491 -- hereinafter referred to as "BBA of 1995"), as vetoed by President Clinton, allows taxpayers a nonrefundable tax credit of $500 for each qualifying child under the age of 18. The credit amount is not indexed for inflation and the credit is not sunset.

To be a qualifying child, an individual has to satisfy a relationship test and a dependency test. The relationship test is the same as in the President's proposal, except that an individual can also be a descendant of a son or daughter of the taxpayer. The dependency test is the same as in the President's proposal, except that the term "dependent" does not include an individual who is a resident of a country contiguous to the United States unless (1) that individual is an adopted child of a taxpayer who is a U.S. citizen or national and (2) for the taxpayer's entire taxable year, the individual is a member of the taxpayer's household and has as his or her principal place of abode the home of the taxpayer.

For taxpayers with AGI in excess of certain thresholds, the allowable child credit is reduced by $25 for each $1,000 of AGI (or fraction thereof) in excess of the threshold. Thus, the size of the phaseout range is proportional to the number of qualifying children. For married taxpayers filing joint returns, the threshold is $110,000. For taxpayers filing single or head of household returns, the threshold is $75,000. For married taxpayers filing separate returns, the threshold is $55,000. These thresholds are not indexed for inflation.

The credit is effective October 1, 1995. The portion of the child credit that is effective for the period from October 1, 1995, through December 31, 1995, is provided to taxpayers through a special procedure.

2. Deduction for higher education expenses

Present Law

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's adjusted gross income (AGI).

Education expenses that are reimbursed by the employer are excludable from the employee's gross income as a working condition fringe benefit (sec. 132(d)) if the education qualifies as work related under section 162. A special rule allowed an employee to exclude from gross income up to $5,200 paid by his or her employer for educational assistance, regardless of whether the education maintained or improved a skill required by the employee's current position (sec. 127). That special rule for employer-provided educational assistance expired after 1994.

Another special rule, section 135, provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[3] "Qualified higher education expenses" include tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's AGI during the year the bond is redeemed. To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

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[3] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations.

Description of Proposal

A taxpayer would be allowed an above-the-line deduction for qualified educational expenses paid during the taxable year for the education or training of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents at an institution of higher education. The deduction would be allowed in computing a taxpayer's AGI and could be claimed regardless of whether the taxpayer itemizes deductions. In 1996, 1997, and 1998, the maximum deduction allowed per taxpayer return would be $5,000. In 1999 and 2000, the maximum deduction would be increased to $10,000. Under the proposal, the deduction would not be available for taxable years beginning after December 31, 2000. The deduction would be phased out ratably for taxpayers with modified AGI between $70,000 and $90,000 ($100,000 and $120,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). For the year 2000, the income phase-out ranges would be indexed for inflation.

Qualified educational expenses would be defined as tuition and fees required for the enrollment or attendance of an eligible student (e.g., registration fees, laboratory fees, and extra charges for particular courses) at an institution of higher education. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal expenses unrelated to a student's academic course of instruction would not be deductible. The expenses of education involving sports, games, or hobbies would not be qualified educational expenses unless the education is part of a degree program (or relate to the student's current profession).

An "eligible student" would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an institution of higher education. The student must pursue a course of study on at least a half-time basis or must be enrolled in a course which enables the student to improve current job skills or to acquire new job skills. In addition, the student cannot be enrolled in an elementary or secondary school, and cannot be a nonresident alien. Educational institutions would determine what constituted a half-time basis for individual programs.

The term "institution of higher education" would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions must have entered into an agreement

with the Department of Education to participate in the student loan program. This definition includes colleges and universities, and certain vocational and proprietary institutions.

The amount of qualified educational expense (prior to the application of the $5,000 or $10,000 deduction limitation) would be reduced by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, qualified educational expenses would be reduced by scholarship or fellowship grants (received with respect to the student for the taxable year) that are excludable from gross income under section 117 and any educational assistance received as veterans' benefits.[4] Similarly, qualified educational expenses would be reduced by proceeds from Series EE savings bonds that are excludable by the taxpayer under present-law section 135 for the taxable year. However, no reduction would be required for a gift, bequest, devise or inheritance within the meaning of section 102(a).

Qualified educational expenses would be deductible in the year the expenses are paid, subject to the requirement that the education commences or continues during that year or during the first three months of the next year. Qualified educational expenses paid with the proceeds of a loan generally would be deductible (rather than repayment of the loan itself). Normal tax benefit rules would apply to refunds (and reimbursements through insurance) of previously deducted tuition and fees.

The proposal would not affect deductions claimed under any other section of the Code, except that any amount deducted under another section of the Code could not also be deducted under this provision. A student would not be eligible to claim a deduction under this provision on his or her own tax return if that student could be claimed as a dependent of another taxpayer.

Effective Date

The proposal would be effective for qualified educational expenses paid after December 31, 1995. The proposed deduction would not be available for taxable years beginning after December 31, 2000.

Legislative Background

The proposal is identical to the proposal contained in the President's fiscal year 1996 budget proposal (the "Middle-Class Bill of Rights Tax Relief Act of 1995," introduced on February 16, 1995, as H.R. 980 by Representatives Gephardt and Gibbons and as S. 452 by Senators Moynihan and Daschle) and the proposal contained in the President's seven-year balanced budget proposal released on December 7, 1995, except that those proposals allowed

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[4] For example, if during a taxable year, a taxpayer pays $9,000 for college tuition, but receives a $4,000 tax-free scholarship to cover some of those same tuition expenses, the taxpayer will be deemed to have paid $5,000 "qualified educational expenses" under the proposal.

taxpayers to continue to claim a deduction for certain higher education expenses in taxable years beginning after 2000.

The BBA of 1995 provides that certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. In order for the interest to be deductible under this provision, the indebtedness must be incurred to pay for the qualified higher education expenses of the taxpayer or the taxpayer's spouse. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. The deduction is phased out ratably over the following modified adjusted gross income ranges: joint filers ($65,000-$85,000) and unmarried individuals ($45,000-$65,000). For taxable years beginning after 1996, the income phaseout ranges are indexed for inflation.

B. Provisions Relating to Individual Retirement Plans

Present Law

In general

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

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of $2,000 or 100 percent of an individual's compensation (earned income in the case of self-employed individuals). A single taxpayer is permitted to make the maximum deductible IRA contribution for a year if the individual is not an active participant in an employer-sponsored retirement plan for the year or the individual has adjusted gross income ("AGI") of less than $25,000. A married taxpayer filing a joint return is permitted to make the maximum deductible IRA contribution for a year if neither spouse is an active participant in an employer-sponsored plan or the couple has combined AGI of less than $40,000.

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

Spousal IRAs

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 the lesser of $2,250 or the individual's compensation.

Nondeductible IRA contributions

Individuals may make nondeductible IRA contributions to the extent deductible contributions are not allowed because of the AGI phaseout and active participant rules. A taxpayer may also elect to make nondeductible contributions in lieu of deductible contributions. Thus, any individual may make nondeductible contributions up to the excess of (1) the lesser of $2,000 or 100 percent of compensation over (2) the IRA deduction claimed by the individual. As is the case with earnings on deductible IRA contributions, earnings on nondeductible contributions are not subject to income tax until withdrawn.

Taxation of withdrawals

Amounts withdrawn from IRAs (other than amounts that represent a return of nondeductible contributions) are includible in income when withdrawn.

To discourage the use of amounts contributed to an IRA for nonretirement purposes, withdrawals from an IRA prior to age 59-1/2, death, or disability are generally subject to an additional 10-percent income tax. The 10-percent tax is intended to recapture at least a portion of the tax benefit of the IRA. The 10-percent tax does not apply to withdrawals that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and the taxpayer's designated beneficiary. A similar early withdrawal tax applies to withdrawals from qualified retirement plans.

Elective deferrals

Under a qualified cash or deferred arrangement, an individual can elect to have compensation paid in cash or contributed to a tax-qualified retirement plan. Amounts contributed at the election of the employee are referred to as elective deferrals. Like other qualified plan contributions, elective deferrals are not includible in income until withdrawn from the plan. Qualified cash or deferred arrangements are subject to the same rules applicable to qualified plans generally, and are also subject to additional requirements. One of these additional requirements is that the maximum amount of elective deferrals that can be made in a year by an individual is limited to $9,240 in 1995. This dollar limit is indexed for inflation in $500 increments. A similar limit applies to elective deferrals under similar arrangements (e.g., tax-sheltered annuities).

Description of Proposal

In general

In general, the proposal would (1) double the present-law income limits on deductible IRA contributions and increase the income phase-out range to $20,000 (so that, in 1996, the income phase-out range would be $80,000 to $100,000 of AGI for married taxpayers and $50,000 to $70,000 for single taxpayers); (2) index the $2,000 IRA contribution limit in $500 increments; (3) coordinate the IRA contribution limit with the elective deferral limit; (4) create nondeductible tax-free IRAs called "Special IRAs"; and (5) provide an exception from the 10-percent early withdrawal tax for IRA distributions used for higher education expenses, first-time homebuyer expenses, extraordinary medical expenses (including long-term care expenses) and distributions to individuals who have been receiving unemployment compensation for at least 12 weeks.

Deductible IRA contributions

The proposal would increase the income limits at which the IRA deduction is phased out for active participants in employer-sponsored retirement plans. In 1996, the maximum IRA deduction would be phased out between $80,000 and $100,000 of AGI for married taxpayers and between $50,000 and $70,000 of AGI for single taxpayers. The income thresholds would be indexed for inflation in $5,000 increments, beginning after 1996.

The IRA deduction limit would be coordinated with the limit on elective deferrals so that the maximum allowable IRA deduction for a year could not exceed the excess of the elective deferral limit over the amount of elective deferrals made by the individual.

The proposal would provide that the exception to the early withdrawal tax for distributions after age 59-1/2 does not apply to amounts that have been held in an IRA for less than 5 years.

Inflation adjustment for IRA contribution limit

The $2,000 IRA deduction limit would be indexed for inflation in $500 increments, beginning after 1996.

Nondeductible tax-free IRAs

Under the proposal, individuals who are eligible to make deductible IRA contributions also would be eligible to make nondeductible contributions to a Special IRA. Special IRAs generally would be treated the same as IRAs, but also would be subject to special rules. The IRA deduction limit and the limit on contributions to Special IRAs would be coordinated. Thus, the maximum contribution that could be made in a year to a Special IRA would be the excess of the IRA deduction limit applicable to the individual over the amount of the individual's deductible IRA contributions. Distributions from Special IRAs would not be includible in income to the extent attributable to contributions that had been in the Special IRA for at least five years. Withdrawals of earnings from Special IRAs before five years would be subject to income tax, and also would be subject to the 10-percent tax on early withdrawals unless used for one of the special purposes described below (or a present-law exception to the tax, other than the exception for distributions after age 59-1/2 applies).

An individual whose AGI for a year falls below the upper end of the eligibility thresholds for deductible IRAs could convert an existing IRA into a Special IRA without being subject to the 10-percent tax on early withdrawals. The amount transferred from the deductible IRA to the Special IRA generally would be includible in the individual's income in the year of the transfer. However, if a transfer is made before 1997, the amount to be included in the individual's income with respect to the transfer would be spread evenly over four taxable years.

Special purpose withdrawals

The proposal would provide exemptions from the 10-percent early withdrawal tax for distributions from IRAs or Special IRAs used for certain special purposes. Penalty-free withdrawals would be withdrawals (1) for qualified higher education expenses, (2) for acquisition of a principal residence for a first-time homebuyer, (3) for medical expenses (including long-term care expenses) in excess of 7.5 percent of AGI, and (4) made by individuals who have been receiving unemployment compensation for at least 12 consecutive weeks.

Effective Date

The proposal would generally be effective for taxable years beginning after December 31, 1995, and before January 1, 2001.

Legislative Background

In general

A substantially similar proposal was contained in the President's seven-year balanced budget proposal released on December 7, 1995. In addition, the proposal is substantially similar to the President's budget proposal, as contained in the "Middle-Class Bill of Rights Tax Relief Act of 1995," introduced on February 16, 1995, as H.R. 980 by Representatives Gephardt and Gibbons and as S. 452 by Senators Moynihan and Daschle.

The proposal is similar to the provisions of the BBA of 1995 relating to IRAs (secs. 11011 - 11016). The BBA of 1995 (1) increases the income limits on deductible IRA contributions and provide that an individual is not an active participant in an employer-sponsored plan merely because his or her spouse is an active participant; (2) indexes the $2,000 IRA contribution limit in $500 increments; (3) permits married couples to contribute up to $2,000 to an IRA for each spouse; (4) creates nondeductible tax-free IRAs, called American Dream IRAs ("AD IRAs"); and (5) permits penalty-free withdrawals from deductible and nondeductible IRAs for first-time home purchase, higher education expenses, extraordinary medical expenses (including long-term care expenses), and persons who have been receiving unemployment compensation for at least 12 weeks. The provisions of the BBA of 1995 are described in more detail below.

Deductible IRA contributions

The BBA of 1995 phases up the income limits on deductible IRA contributions in $5,000 increments, and increases the income phase-out range for married couples to $20,000 in $2,500 increments. After the income thresholds are $85,000 for single taxpayers and $100,000 for married taxpayers, the thresholds are indexed for inflation in $1,000 increments.

In addition, the BBA of 1995 provides that a spouse is not considered an active participant in an employer-sponsored retirement plan merely because his or her spouse is an active participant.

Inflation adjustment for IRA contribution limit

The proposal is the same as the BBA of 1995.

Spousal IRAs

The BBA of 1995 provides that contributions of up to $2,000 can be made to an IRA for each spouse in a married couple.

Nondeductible tax-free IRAs

The BBA of 1995 creates a nondeductible tax-free IRA similar to the Special IRA, called an AD IRA. An AD IRA is generally subject to the same rules as a deductible IRA, but some special rules apply. Contributions to an AD IRA are nondeductible. Withdrawals from an AD IRA are not taxable if made (1) after the 5-taxable year period beginning with the taxable year for which the individual first made a contribution to an AD IRA and (2) either (a) the individual has attained age 59-1/2, died, or become disabled, or (b) the withdrawal is a special purpose withdrawal. Special purpose withdrawals made within the 5-taxable year period are includible in income (to the extent attributable to earnings), but are not subject to the 10-percent early withdrawal tax. Other withdrawals are includible in income to the extent attributable to earnings on contributions and subject to the 10-percent early withdrawal tax.

No more than $2,000 can be contributed annually to all IRAs of an individual. However, the income limits applicable to deductible IRAs do not apply to AD IRAs.

If an individual converts a present-law IRA into an AD IRA after December 31, 1995, and before January 1, 1998, the amount that would have been includible in income had the individual withdrawn the amount converted is includible in income ratably over 4 years. The early withdrawal tax does not apply to such conversions.

Special purpose withdrawals

The proposal is generally the same as the BBA of 1995, except that, under the BBA of 1995, only first-time home buyer expenses up to $10,000 qualify as a special purpose withdrawal.

Effective date

The IRA provisions of the BBA of 1995 generally are effective for taxable years beginning after December 31, 1995.

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

Present Law

Under present law, self-employed individuals can deduct up to 30 percent of the cost of health insurance expenses for themselves and their spouse and dependents.

Description of Proposal

The proposal would increase the deduction for health insurance expenses of self-employed individuals as follows: 35 percent in 1996 and 1997, 40 percent in 1998, 45 percent in 1999, and 50 percent in 2000. In 2001 and thereafter, the deduction would be reduced to 30 percent of health insurance expenses.

Effective Date

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

Legislative Background

The provision is similar to a proposal contained in the President's seven-year balanced budget proposal released on December 7, 1995, except that the December 7 proposal would continue the deduction at 50 percent in 2000 and thereafter.

The proposal is also similar to a provision in the BBA. Under the BBA, the 30-percent deduction is increased as follows: 35 percent in 1998 and 1999, 40 percent in 2000 and 2001, and 50 percent in 2002 and thereafter.

II. LIMITATIONS ON CORPORATE AND OTHER TAX PROVISIONS

A. Expatriation Tax Provisions

Present Law

U.S. citizens and residents generally are subject to U.S. income tax on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. business.

A U.S. citizen who relinquishes citizenship with a principal purpose of avoiding U.S. taxes is subject to special tax rules for ten 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 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 nonresident aliens, for ten years after expatriation. Solely for this purpose, gains on the sale of property located in the United States and stocks and 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 than the amount otherwise determined for nonresident aliens.

Rules applicable in the estate and gift tax contexts expand the categories of items that are subject to estate and gift taxes in the case of a U.S. citizen who relinquished citizenship with a principal purpose of avoiding U.S. taxes within the ten-year period ending on the date of transfer. Certain U.S. property controlled by such individuals and related persons is included in the individual's estate, and gifts of U.S.-situs tangible property by such individuals 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 bill 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 bill. 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 may 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, on a property-by-property basis, 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 would be calculated based on the fair market value of the property on the date of expatriation, but the tax (plus interest thereon) would not be due until 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 would also be permitted provided that the individual establishes to the satisfaction of the Secretary of the Treasury that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct such situation, the deferred expatriation tax and interest with respect to such property would become due. As a further condition to making this election, the individual would be required to consent to the waiver of any treaty rights that would preclude the collection of the expatriation tax.

Interests in trusts

In general

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" is 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 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 assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she potentially could receive under the terms of the trust instrument). The expatriation tax imposed on such gains generally would be collected when the individual receives distributions from the trust, or, if earlier, upon the

individual's death. Interest would be charged for the period between the date of expatriation and the date on which the tax is paid.

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

If an individual's interest in a trust is vested as of the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest would be determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest would be determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules 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 be equal to the lesser of (1) the tax calculated under the rules for nonqualified trust interests applied as of such date or (2) the deferred tax amount with respect to the trust interest as of such date.

If the individual agrees to waive any treaty rights that would preclude collection of the tax, the tax imposed under this provision with respect to distributions from a qualified trust to the individual would be 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 would be covered by the expatriation tax. This election would be an "all-or-nothing" election; an individual would not be permitted to elect this treatment for some property but not other property. The election, 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 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 intent 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 be treated as having relinquished citizenship on the date a CLN is issued or a certificate of naturalization is cancelled. The date of relinquishment of citizenship determined under the bill 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)) would, however, 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 that 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). Such entity 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) five 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.

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.

Legislative Background

An identical proposal was included in the BBA of 1995, as passed by the Senate.

Similar proposals to amend the expatriation tax provisions were also included in the President's fiscal year 1996 budget proposal, in H.R. 981 introduced by Representatives Gephardt and Gibbons and S. 453 introduced by Senators Daschle and Moynihan, in S. 700 introduced by Senator Moynihan and H.R. 1535 introduced by Representative Gibbons, and in the President's seven-year balanced budget proposal released December 7, 1995.

The conference agreement on the BBA of 1995 includes provisions to expand the present law provisions that subject U.S. citizens who lose citizenship for tax avoidance purposes to special tax rules for ten years after such loss of citizenship. The expatriation provisions included in the conference agreement are substantially similar to the proposal contained in H.R. 1812 introduced by Representative Archer. The conference agreement extends the expatriation provisions to apply not only to U.S. citizens who lose citizenship but also to certain long-term residents of the United States whose U.S. residency is terminated. The conference agreement subjects certain individuals to the expatriation tax provisions without inquiry as to their motive for expatriating, and allows certain categories of citizens to show an absence of tax-avoidance

motives only if they request a ruling from the Secretary of the Treasury. The conference agreement expands the categories of income and gains that are subject to tax under the expatriation tax provisions and includes provisions designed to eliminate the ability to engage in certain transactions that under present law partially or completely circumvent the reach of the expatriation tax provisions. In addition, the conference agreement contains information reporting and information sharing provisions to enhance compliance with the expatriation tax provisions.

B. Corporate Tax Reforms

1. Require gain recognition for certain extraordinary dividends

Present Law

A corporate shareholder is generally allowed to deduct a certain percentage of dividends received from another corporation. A corporate shareholder who receives an "extraordinary" dividend is required to reduce the basis of the stock with respect to which the dividend was received by the non-taxed portion of the dividend (section 1059). Whether a dividend is "extraordinary" is determined by reference to, among other things, the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non prorata redemption or partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in stock with respect to which an extraordinary dividend is received, the excess is taxed as gain at the time of a sale or disposition of such stock.

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend. A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. The determination whether a redemption is essentially equivalent to a dividend includes a reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of other property received in a reorganization contain a similar reference (section 356(a)(2)).

Description of Proposal

The extraordinary dividend rules of section 1059 would be amended to provide that a corporate shareholder will recognize gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership. In addition, immediate gain recognition is required whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. Reorganizations or other exchanges involving amounts that are treated as dividends under section 356(a)(2) of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e).

Effective Date

The proposal is generally effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on that date, or a tender offer outstanding on that date. However, in applying the new gain recognition rules to any distribution that is not a partial liquidation, a non pro rata redemption, or a redemption that is

treated as a dividend by reason of options, September 13, 1995 is substituted for May 3, 1995 in applying the transition rules.

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

Legislative Background

A substantially similar proposal is contained in the BBA of 1995 and in the President's seven-year balanced budget proposal released on December 7, 1995.

2. Registration of confidential corporate tax shelters

Present Law

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

A penalty may be imposed against an organizer who fails without reasonable cause to timely register the shelter or who provides false or incomplete information with respect to it. The penalty is the greater of one percent of the aggregate amount invested in the shelter or $500. Any person claiming any tax benefit with respect to a shelter must report its registration number on her return. Failure to do so without reasonable cause will subject that person to a $250 penalty (sec. 6707(b)(2)).

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

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

Description of Proposal

The proposal would require a promoter of a corporate tax shelter to register the shelter with the Secretary. Registration would be required not later than the next business day after the day when the tax shelter is first offered to potential users. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant would be required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

A corporate tax shelter is any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of $100,000.

A transaction is offered under conditions of confidentiality if: (a) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (b) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter includes specified related parties.

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

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

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

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

Intentional disregard of the requirement to register by either a promoter or a participant increases the 50-percent penalty to 75 percent of the applicable fees.

Effective Date

The proposal would apply to any tax shelter offered to potential participants after the date the Treasury Department issues guidance with respect to the filing requirements.

Legislative Background

An identical proposal is contained in the President's seven-year balanced budget proposal released on December 7, 1995 and in the BBA of 1995.

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

Present Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[5] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured (sec. 101(a)). The policyholder may borrow with respect to the life insurance contract without affecting these exclusions, subject to certain limitations.

The limitations on borrowing with respect to a life insurance contract under present law provide that no deduction is allowed for any interest paid or accrued on any indebtedness with respect to one or more life insurance policies owned by the taxpayer (including those in which the taxpayer has any interest) covering the life of any individual who (1) is an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of such debt with respect to policies covering the individual exceeds $50,000 (sec. 264(a)(4)).

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[5] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional ten percent tax is imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

Further, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract.[6] An exception to the latter rule is provided, permitting deductibility of interest on bona fide debt that is part of such a plan, if no part of 4 of the annual premiums due during the first 7 years is paid by means of debt (the "4-out-of-7 rule") (sec. 264(c)(1)). Provided the transaction gives rise to debt for Federal income tax purposes and provided the 4-out-of-7 rule is met,[7] a company may under present law borrow up to $50,000 per employee, officer, or financially interested person to purchase or carry a life insurance contract covering such a person, and is not precluded under section 264 from deducting the interest on the debt, even though the earnings inside the life insurance contract (inside buildup) are tax-free, and in fact the taxpayer has full use of the borrowed funds.

Description of Proposal

Under the proposal, no deduction would be allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) financially interested in any trade or business carried on by the taxpayer, regardless of the aggregate amount of debt with respect to policies or contracts covering the individual.

An exception would be provided retaining present law for interest on indebtedness with respect to life insurance policies covering up to 25 key persons. A key person would be an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that could be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 10 individuals. Interest paid or accrued on debt with respect to a life insurance contract covering a key person would be deductible only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month interest is paid or accrued.

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[6] The statute provides that the $50,000 limitation applies only with respect to contracts purchased after June 20, 1986. However, additional limitations are imposed on the deductibility of interest with respect to single premium contracts (sec. 264(a)(2)), and on the deductibility of premiums paid on a life insurance contract covering the life of any officer or employee or person financially interested in a trade or business of the taxpayer when the taxpayer is directly or indirectly a beneficiary under the contract (sec. 264(a)(1)).

[7] Interest deductions are disallowed if any of the disallowance rules of section 264(a)(2) - (4) apply. The disallowance rule of section 264(a)(3) is not applicable if one of the exceptions of section 264(c), such as the 4-out-of-7 rule (sec. 264(c)(1)) is satisfied. In addition to the specific disallowance rules of section 264, generally applicable rules of tax law apply.

Effective Date

The proposal generally would be effective with respect to interest paid or accrued after October 13, 1995 (subject to a phase-in rule).

The phase-in rule would provide that with respect to debt incurred before January 1, 1996, any otherwise deductible interest paid or accrued after October 13, 1995, and before January 1, 1999, would be allowed to the extent the rate of interest does not exceed the lesser of (1) the borrowing rate specified in the contract as of October 13, 1995, or (2) a percentage of Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month the interest is paid or accrued. For interest paid or accrued after October 13, 1995, and before January 1, 1996, the percentage of the Moody's rate would be 100 percent; for interest paid or accrued in 1996, the percentage would be 90 percent; for interest paid or accrued in 1997, the percentage would be 80 percent; for 1998, the percentage would be 70 percent; for 1999 and thereafter, the percentage would be 0 percent. Only interest that would have been allowed as a deduction but for the provision would be allowed under the phase-in. Interest that is deductible under the phase-in rules would not include interest on borrowings by the taxpayer with respect to contracts on the lives of more than 20,000 insured individuals, effective for interest paid or accrued after December 31, 1995. For this purpose, all persons treated as a single employer would be treated as one taxpayer.

An exception would be provided under the effective date with respect to any life insurance contract entered into during 1994 or 1995. In the case of such contracts, with respect to debt incurred before January 1, 1997, no deduction would be allowed for interest paid or accrued after December 31, 1996, except with respect to policies that satisfy the key person exception, and except as provided under the phase-in rule.

The proposal generally would not apply to interest on debt with respect to contracts purchased on or before June 20, 1986 (thus generally continuing the effective date provision of the $50,000 limitation enacted in the 1986 Act). If the policy loan interest rate under such a contract provides for a fixed rate of interest, then interest on such a contract paid or accrued after October 13, 1995, would be allowable only to the extent the fixed rate of interest does not exceed Moody's Corporate Bond Yield Average--Monthly Average Corporates for the month in which the contract was purchased. If the policy loan interest rate under such a contract does not provide for a fixed rate of interest, then interest on such a contract paid or accrued after October 13, 1995, would be allowable only to the extent the rate of interest for each fixed period selected by the taxpayer does not exceed Moody's Corporate Bond Yield Average--Monthly Average Corporates, for the second month immediately preceding the beginning of the fixed period. The fixed period must be 12 months or less.

Any amount included in income during 1996, 1997, or 1998, that is received under a contract described in the proposal on the complete surrender, redemption or maturity of the contract or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract, would be includable ratably over the first four taxable

years beginning with the taxable year the amount would otherwise have been includable. Utilization of this 4-year income-spreading rule would not cause interest paid or accrued prior to January 1, 1999, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1) (i.e., a contract in which substantially all of the premiums are paid within 4 years after the date of purchase). In addition, the lapse of a contract after October 13, 1995, due to nonpayment of premiums, would not cause interest paid or accrued prior to January 1, 1999, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1).

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

The proposal would not affect the determination of whether interest is deductible under present-law rules (including whether interest paid or accrued during the phase-in period is otherwise deductible), and the IRS would not be precluded from applying common-law doctrines or statutory or other tax rules to challenge corporate-owned life insurance plans to which present-law rules apply.

Legislative Background

The proposal is substantially similar to the provision relating to disallowance of the interest deduction for corporate-owned life insurance policy loans that was included in the BBA of 1995. The proposal is similar to a proposal contained in the President's seven-year balanced budget proposal released on December 7, 1995; that proposal, however, had different phase-in and transition rules.

4. Phase out preferential treatment for certain large farm corporations required to use accrual accounting

Present Law

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

A provision of the Revenue Act of 1987 ("1987 Act") requires a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting for its

farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where at least 50 percent or more of the stock of the corporation is held by one family (or in some limited cases, two or three families).

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

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

Description of Proposal

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

Effective Date

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

Legislative Background

The proposal is identical to the provision contained in the BBA of 1995 and a proposal contained in the President's seven-year balanced budget proposal released on December 7, 1995.

5. Modification of Puerto Rico and possessions tax credit (sec. 936)

Present Law

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

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

A domestic corporation that has elected the section 936 credit and that satisfies these two conditions for a taxable year generally is entitled to a credit 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 the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes). In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage is phased down, beginning at 60 percent for 1994 and reaching 40 percent for 1998 and thereafter. The amount of the section 936 credit attributable to QPSII is not subject to these limitations.

Description of Proposal

The proposal would phase out the section 936 credit determined under the applicable percentage limit ratably over five years beginning in 1997. Under the proposal, taxpayers using the applicable percentage limit would continue to be subject to present law for 1996; accordingly, the section 936 credit attributable to possession business income for 1996 would be subject to the present-law applicable percentage limit of 50 percent of the amount otherwise allowed. For 1997, the section 936 credit attributable to possession business income would be reduced to 80 percent of the present-law applicable 45-percent limit; accordingly, the section 936

credit attributable to possession business income for 1997 would be limited to 36 percent of the amount otherwise allowed. For 1998, the section 936 credit attributable to possession business income would be reduced to 60 percent of the present-law applicable 40-percent limit; accordingly, the section 936 credit attributable to possession business income for 1998 would be limited to 24 percent of the amount otherwise allowed. For 1999, the section 936 credit attributable to possession business income would be reduced to 40 percent of the present-law applicable 40-percent limit; accordingly, the section 936 credit attributable to possession business income for 1999 would be limited to 16 percent of the amount otherwise allowed. For 2000, the section 936 credit attributable to possession business income would be reduced to 20 percent of the present-law applicable 40-percent limit; accordingly, the section 936 credit attributable to possession business income for 2000 would be limited to 8 percent of the amount otherwise allowed. For 2001 and thereafter, the section 936 credit determined under the applicable percentage limit would no longer be available.

In addition, the proposal would permit taxpayers whose economic activity limit exceeds its possession business income for a taxable year to carry forward such excess limit for up to five years.

Finally, the proposal provides that the revenue attributable to the proposed changes to the section 936 credit would be used for the purposes of carrying out programs authorized under the Social Security Act and to promote the creation of jobs.

Effective Date

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

Legislative Background

A substantially similar proposal was contained in the President's seven-year balanced budget proposal released December 7, 1995.

The BBA of 1995 generally repeals section 936 for taxable years beginning in 1996 and thereafter, with transition rules under which certain taxpayers are eligible to claim section 936 credits for a ten-year period.

6. Restrict like-kind exchange rules for certain personal property

Present Law

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in trade or business or for investment (sec. 1031). In general, any kind of real estate is treated as of a like-kind with other real property as long as the properties are both located either within or outside

the United States. Different types of personal property are not treated as like-kind unless such properties are of a "like class." In addition, certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange.

Description of Proposal

The proposal would provide that personal property located in the United States and personal property located outside the United States are not "like-kind" properties. For this purpose, the location of the properties would be determined at the time of the exchange. In addition, the property surrendered in the exchange must have been used during the 24 months immediately prior to the exchange in predominantly the same use (i.e., foreign or domestic) as at the time of the exchange. Similarly, for section 1031 to apply, property received in the exchange must continue in the same use (i.e., foreign or domestic) for the 24 months immediately after the exchange.

Effective Date

The proposal would be effective for exchanges on or after December 7, 1995, unless the exchange is pursuant to a binding contract in effect on such date and all times thereafter. A contract would not fail to be considered to be binding solely because (1) it provides for a sale in lieu of an exchange or (2) either the property to be disposed of as relinquished property or the property to be acquired as replacement property (whichever is applicable) was not identified under the contract before December 7, 1995.

Legislative Background

The present-law provision that requires exchanged real properties to be both located in or outside the United States for section 1031 to apply was enacted as part of the Omnibus Budget Reconciliation Act of 1989. The proposal is substantially similar to a provision contained in the President's seven-year balanced budget proposal released on December 7, 1995.

7. Repeal of financial institution transition rule to interest allocation rules

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 interest expense (sec. 864(e)(5)(B)). 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.

Legislative Background

An identical provision is included in the BBA of 1995.

8. Conversion of large corporations into S corporations treated as complete liquidation (sec. 1374)

Present Law

The income of a corporation described in subchapter C of the Internal Revenue Code (a "C corporation") is subject to corporate-level tax when the income is earned and individual-level tax when the income is distributed. The income of a corporation described in subchapter S of the Internal Revenue Code (an "S corporation") generally is subject to individual-level, but not corporate-level, tax when the income is earned. The income of an S corporation generally is not subject to tax when it is distributed to the shareholders. The tax treatment of an S corporation is similar to the treatment of a partnership or sole proprietorship.

The liquidation of a subchapter C corporation generally is a taxable event to both the corporation and its shareholders. Corporate gain is measured by the difference between the fair market values and the adjusted bases of the corporation's assets. The shareholder gain is measured by the difference between the value of the assets distributed and the shareholder's adjusted basis in his or her stock. The conversion of a C corporation into a partnership or sole proprietorship is treated as the liquidation of the corporation.

The conversion from C to S corporation status (or the merger of a C corporation into an S corporation) generally is not a taxable event to either the corporation or its shareholders.

Certain rules attempt to limit the potential for C corporations to avoid corporate-level tax by shifting appreciated assets to S corporation status prior to the recognition of such gains.

Specifically, an S corporation is subject to a tax computed by applying the highest marginal corporate tax rate to the lesser of (1) the S corporation's recognized built-in gains or (2) the amount that would be taxable income if such corporation was not an S corporation (sec. 1374). For this purpose, a recognized built-in gain generally is any gain the S corporation recognizes from the disposition of any asset within a 10-year recognition period after the conversion from C corporation status or any income that is properly taken into account during the recognition period that is attributable to prior periods. However, a gain is not a recognized built-in gain if the taxpayer can establish that the asset was not held by the corporation on the date of conversion or to the extent the gain exceeds the amount of gain that would have been recognized on such date. In addition, the cumulative amount of recognized built-in gains that an S corporation must take into account may not exceed the amount by which the fair market value of the corporation's assets exceeds the aggregated adjusted basis of such assets on the date of conversion from C corporation status. Finally, net operating loss or tax credit carryovers from years in which the corporation was a C corporation may reduce or eliminate the tax on recognized built-in gains.

The amount of built-in gain that is subject to corporate-level tax also flows-through to the shareholders of the S corporation as an item of income subject to individual-level tax. The amount of tax paid by the S corporation on built-in gains flows-through to the shareholders as an item of loss that is deductible against such built-in gain income on the individual level.

Description of Proposal

The proposal would repeal section 1374 for large S corporations. A C-to-S corporation conversion (whether by a C corporation electing S corporation status or by a C corporation merging into an S corporation) would be treated as a liquidation of the C corporation followed by a contribution of the assets to an S corporation by the recipient shareholders. Thus, the proposal would require immediate gain recognition by both the corporation (with respect to its appreciated assets) and its shareholders (with respect to their stock) upon the conversion to S corporation status.

For this purpose, a large S corporation is one with a value of more than $5 million at the time of conversion. The value of the corporation would be the fair market value of all the stock of the corporation on the date of conversion.

Effective Date

The proposal would be effective for subchapter S elections made after December 7, 1995. The proposal would apply to acquisitions (e.g., the merger of a C corporation into an S corporation) after December 7, 1995, unless made pursuant to a binding contract in effect on such date and all times thereafter.

Legislative Background

The proposal is substantially similar to a provision in the President's seven-year balanced budget proposal released on December 7, 1995.

9. Modification of taxble years to which net operating losses may be carried

Present Law

The net operating loss ("NOL") of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) may be carried back three years and carried forward fifteen years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. Special rules apply to REITs (no carrybacks), specified liability losses (10-year carryback), excess interest losses (no carrybacks), and net capital losses of corporations (carryforward limited to five years).

Description of Proposal

The proposal would limit the NOL carryback period to one year and extend the NOL carryforward period to 20 years. The proposal would not apply to the carryback rules relating to REITs, specified liability losses, excess interest losses, and corporate capital losses.

Effective Date

The proposal would be effective for NOLs arising in taxable years beginning after December 31, 1999.

Legislative Background

The proposal is substantially similar to a provision contained in the President's seven-year balance budget proposal released on December 7, 1995. The proposal released on December 7, 1995, would have be effective for NOLs arising in taxable years beginning after December 31, 1995, rather than taxable years beginning after December 31, 1999.

10. Constructive sales treatment for appreciated financial positions

Present Law

In general, gain is realized when a taxpayer disposes of property in exchange for money or other property. Gain is determined by comparing the amount realized with the adjusted basis of the particular property sold. In the case of corporate stock, the basis of shares purchased at different dates or different prices is determined by reference to the actual lot sold if it can be identified, and if identification cannot be made, then by reference to the basis of the earliest of

the lots purchased. Certain securities held by dealers, and certain financial contracts are "marked-to-market" and gain on these instruments is recognized as it accrues.

In the case of a short sale, i.e., a sale of property which the taxpayer does not own, the sale is deemed consummated at the time of delivery of the property to close the short sale. If a taxpayer sells short property at the time it owns substantially identical appreciated property, (a "short sale against the box"), the form of the transaction is respected for income tax purposes and gain on the substantially identical property is not recognized at the time of the short sale. Present law does provide rules to prevent the conversion of short-term capital gain into long-term capital gain where there is a short sale against the box.

Taxpayers may engage in other arrangements, such as "equity swaps" and "notional principal contracts" and options, where the risk of loss and opportunity for gain are shifted to another party (the "counterparty"). These arrangements do not result in the recognition of gain by the taxpayer.

Description of Proposal

Certain transactions in appreciated financial positions would be treated as constructive sales. Gain (but not loss) would be recognized at the time of the transaction as if the property were sold for fair market value at the date of the constructive sale. Proper adjustment would be made in the amount of any gain or loss subsequently realized; and the new holding period of such position would be determined as if such position were originally acquired on the date of the constructive sale.

An appreciated financial position would be defined as any position with respect to any stock, debt instrument partnership interest, or certain actively traded trust instruments, if there would be gain were the position sold. A position would be defined as any interest, including a futures or forward contract, short sale, or option.

A constructive sale of such a position would occur if the taxpayer or a related person (as defined by reference to certain circumstances) enters into one or more positions with respect to the same or substantially identical property which, for some period, substantially eliminates both risk of loss and opportunity for gain on the appreciated financial position; or enters into any other transaction which is marketed or sold as being economically equivalent to any such transaction. A constructive sale would include making a short sale with respect to substantially identical property, the granting of a call option, or the acquisition of a put option with respect to the same or substantially identical property, but only if there is a substantial certainty that such call or put option will be exercised.

Constructive sales would not include any transaction if the appreciated financial position which is part of such transaction is marked to market under present law section 475 (mark to market for securities dealers) or section 1256 (mark to market for futures contracts, options and currency contracts).

A constructive sale also would not include any contract for the sale of any stock, debt instrument, or partnership interest which is not a marketable security (as defined in the section 453(f) rules that apply to installment sales) if the sale occurs within one year after the date such contract is entered into.

A person would be considered related to another for purposes of the proposal if the relationship would result in a disallowance of losses under sections 267 or 707(b) and the transaction is entered into with a view toward avoiding the purposes of the provision.

In the case of a constructive sale of less than all of the appreciated financial positions held by the taxpayer, the provision would apply to such positions in the order in which acquired or entered into.

If there is a constructive sale of any appreciated financial position which is subsequently sold or disposed of while the constructive sale transaction remains open, then solely for purposes of determining whether the taxpayer has entered into a constructive sale of any other appreciated financial position held by the taxpayer, such transaction shall be treated as entered immediately after the sale or disposition.

Effective Date

The proposal would be effective for constructive sales entered into after the date of enactment. It would also apply to constructive sales entered into after January 12, 1996 and before the date of enactment that are not closed before the date which is 30 days after the date of enactment; the proposal would apply to such transactions as if the constructive sale occurred on the date which is 30 days after the date of enactment.

In the case of a decedent dying after the date of enactment, if a constructive sale of an appreciated financial position had occurred before the date of enactment and was open on the day before the decedent's death, such position (and any property related to it, under principles of the provision) would be treated as property constituting rights to receive income in respect of a decedent.

11. Disallowance of interest on indebtedness allocable to tax-exempt obligations

Present Law

In general

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is not subject to tax (tax-exempt obligations) (sec. 265). This rule applies to tax-exempt obligations held by individual and corporate

taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues indebtedness and a related person acquires or holds tax-exempt obligations.[8]

Application to non-financial corporations

In Rev. Proc. 72-18, 1972-1 C.B. 740, the IRS provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, other business enterprises, and banks in certain situations. Under Rev. Proc. 72-18, a deduction is disallowed only when indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt obligations.

This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations exists when the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such obligations are used as collateral for indebtedness. In the absence of direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

Two-percent de minimis exception.-- In the case of an individual, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of the individual's portfolio investments and trade or business assets. In the case of a corporation other than a financial institution or a dealer in tax-exempt obligations, interest on indebtedness generally is not disallowed if during the taxable year the average adjusted basis of the tax-exempt obligations does not exceed 2 percent of the average adjusted basis of all assets held in the active conduct of the trade or business. These safe harbors are inapplicable to financial institutions and dealers in tax-exempt obligations.

Interest on installment sales to State and local governments.--If a taxpayer sells property to a State or local government in exchange for an installment obligation, interest on the obligation may be exempt from tax. Present law has been interpreted to not disallow interest on a taxpayer's indebtedness if the taxpayer acquires nonsalable tax-exempt obligations in the ordinary course of business in payment for services performed for, or goods supplied to, State or local governments.[9]

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[8] Section 7701(f) (as enacted in the Deficit Reduction Act of 1984 (sec. 53(c) of Public Law 98-369)) provides that the Treasury Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of any income tax rules which deal with linking of borrowing to investment or diminish risk through the use of related persons, pass-through entities, or other intermediaries.

[9] R.B. George Machinery Co., 26 B.T.A. 594 (1932) acq. C.B. XI-2, 4; Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669.

Application to financial corporations

In the case of a financial institution, the allocation of the interest expense of the financial institution (which are not otherwise allocable to tax-exempt obligations) is based on the ratio of the average adjusted basis of the tax-exempt obligations acquired after August 7, 1987, to the average adjusted basis of all assets of the taxpayer (Code sec. 265). In the case of an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds), only 20 percent of the interest allocable to such tax-exempt obligations (Code sec. 291(a)(3)).

Description of Proposal

The proposal would extend to all corporations the rule that applies to financial institutions that disallows interest deductions of a taxpayer (that are not otherwise disallowed as allocable under present law to tax-exempt obligations) in the proportion as the average basis of its tax-exempt obligations bears to the average basis of all of the taxpayer's assets. The proposal would not extend the $10 million small-issuer exception to taxpayers which are not financial institutions. Nonetheless, the proposal would not apply, however, to nonsalable tax-exempt debt acquired by a corporation in the ordinary course of business in payment for goods or services sold to a State or local government. Finally, the proposal would apply the interest disallowance provision to all related persons (within the meaning of section 267(f)). Accordingly, in the case of related parties that are members of the same consolidated group, the pro rata disallowance rule would apply as if all the members of the group were a single taxpayer. In the case of related persons that are not members of the same consolidated group, the tracing rules would be applied as if the all of the related persons were treated as a single entity.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995, with respect to obligations acquired after that December 7, 1995.

Legislative Background

Section 10116 of the Omnibus Budget Reconciliation Act of 1987, as passed by the House of Representatives, would have disallowed a deduction for interest on indebtedness allocable to tax-exempt installment obligations. In addition, that provision would have reduced the non-statutory two-percent de minimis test to the lesser of $1 million or two-percent of the taxpayer's adjusted basis of all of the taxpayer's assets. The provision disallowing a deduction for interest allocable to tax-exempt obligations was subsequently deleted in conference.

12. Limit dividends received deduction

a. Reduce dividends received deduction to 50 percent

Present Law

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of that instrument generally is entitled to a deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

Description of Proposal

Under the proposal, the dividends-received deduction available to corporations owning less than 20 percent (by vote and value) of the stock of a U.S. corporation would be reduced to 50 percent of the dividends received.

Effective Date

The proposal would be effective for dividends received or accrued after January 31, 1996.

Legislative Background

A similar proposal was contained in a provision passed by the House in 1988 but not adopted in the final version of the Technical and Miscellaneous Revenue Act of 1988. (See, H.R. Rep.100-795, 100th Cong. 2d Sess. at pp. 467-68).

b. Modify holding period for dividends received deduction

Present Law

If an instrument issued by a U.S. corporation is classified for tax purposes as equity, a corporate holder of the instrument generally is entitled to a dividends received deduction for dividends received on that instrument.

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46- or 91-day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in

the ownership of an equity interest. The holding period must be satisfied only once, rather than with respect to each dividend received.

Description of Proposal

The proposal would provide that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend.

Effective Date

The proposal would be effective for dividends received or accrued after January 31, 1996.

Legislative Background

The proposal is substantially similar to the President's seven-year balanced budget proposal released on December 7, 1995.

13. Treat certain preferred stock as "boot"

Present law

In reorganization transactions within the meaning of section 368, no gain or loss is recognized except to the extent "other property" is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock can be received tax-free in a reorganization, notwithstanding that many preferred stocks are functionally equivalent to debt securities. Upon the receipt of other property, gain but not loss can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this debt-for-debt rule, similar rules generally apply to transactions described in section 351.

Description of Proposal

The proposal would amend both sections 351 and 356 (which applies in the case of reorganizations under section 368) to treat certain preferred stock as "other property" (boot), subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351 or 368, gain but not loss would be recognized.

The proposal would apply to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, including

through a conversion privilege), where (1) the holder has the right to put the stock to the issuer or a related party (within the meaning of sections 267(b) and 707(b)), (2) the stock is subject to mandatory redemption by the issuer or a related party, (3) the issuer (or a related party) has the right to call the stock and, as of the issue date, it is more likely than not that the right will be exercised, or (4) the dividend rate varies in whole or in part directly or indirectly with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose,(1), (2), and (3) are not satisfied if the put or call cannot be exercised, or the redemption cannot occur, within 20 years of the date the instrument is issued.

The following exchanges would be excluded from this gain recognition: (1) an exchange of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock, (3) an exchange of debt securities for preferred stock of the same or lesser value as the adjusted issue price of the debt; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation would be defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family would be defined by reference to the definition in section 447(e). Thus, a family would include children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member would be treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences still apply.

The Treasury Secretary would have regulatory authority to (1) apply installment-sale type rules to preferred stock that is subject to this proposal in appropriate cases, and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., sections 304, 306 and 318).

Effective Date

The proposal would be effective for transactions after the date of announcement (December 7, 1995). However, the proposal would not apply to (1) any stock issued pursuant to a written agreement which was (subject to customary conditions) binding on December 7, 1995 and at all times thereafter, before the stock was issued, (2) any stock issued pursuant to an exchange offer which was outstanding on such date, and (3) any stock which was priced for purposes of issuance before such date.

Legislative Background

The proposal is substantially similar to a proposal in the President's seven-year balanced budget proposal released on December 7, 1995.

14. Deny interest deduction on certain debt instruments

Present Law

Whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid. If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest and the holder generally includes interest in income, subject to certain limitations.

Original issue discount ("OID") on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Section 385(c) provides rules for when an issuer's characterization of an interest in a corporation shall be binding on the issuer and the holders.

Description of Proposal

Under the proposal no deduction would be allowed for interest or OID on an instrument (other than a demand loan) issued by a corporation (or issued by a partnership to the extent of its corporate partners) that (i) has a maximum weighted average maturity of more than 40 years, or (ii) is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including an instrument that is mandatorily convertible or convertible at the issuer's option. In addition, an instrument would be treated as payable in stock of the issuer or a related party if it is part of an arrangement designed to result in the payment of debt with such stock, such as certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised.

The proposal would also clarify that for purposes of section 385(c), an issuer will be treated as having characterized an instrument as equity if the instrument (other than a demand loan) (i) has a maximum term of more than 20 years, and (ii) is not shown as indebtedness on the separate balance sheet of the issuer. For this purpose, in the case of an instrument (described in clause (i)) issued to a related party (other than a corporation) that is eliminated in the consolidated balance sheet that includes the issuer and the holder, the issuer will be treated as having characterized the instrument as equity if a related party issues a related instrument that is

not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not be treated as shown as indebtedness on a balance sheet because it is described as such in footnotes or other narrative disclosures. The proposal would apply only to corporations that file annual financial statements (or are included in financial statements filed) with the Securities and Exchange Commission (SEC), and the relevant balance sheet is the balance sheet filed with the SEC. The proposal would not apply to leveraged leases.

For purposes of the proposal, weighted average maturity and term are determined assuming all options to extend will be exercised.

The proposal is not intended to affect the characterization of instruments as debt or equity under current law.

Effective Date

The proposal would be effective for debt issued on or after December 7, 1995. The proposal would not apply, however, to any debt instrument: (1) issued pursuant to a commitment that was binding before December 7, 1995; (2) issued pursuant to an exchange offer which was outstanding on such date; (3) which was priced for purposes of issuance on or before such date; (4) issued pursuant to a registration statement filed with the Securities and Exchange Commission ("SEC") on or before such date (other than a registration statement which, under 17 CFR 230.415, contemplated a delayed or continuous offering of such debt), but only to the extent that such debt is described in, and the amount of such debt does not exceed the aggregate the amount stated in, such registration statement as of such date; (5) issued pursuant to a registration statement filed with the SEC on or before such date and which, under 17 CFR 230.415, contemplated a delayed or continuous offering of such debt if a prospectus supplement (including a preliminary prospectus supplement) to such registration supplement was filed under 17 CFR 230.424 on or before such date, but only to the extent that such debt is described in, and the amount of such debt does not exceed the aggregate the amount stated in, such prospectus supplement as of such date (or, to the extent a preliminary prospectus supplement as of such date does not state a maximum amount to be issued, the amount expected to be offered may be established by other contemporaneous, written evidence); (6) issued pursuant to a private placement that contemplates resales of the instruments pursuant to 17 CFR 230.144A, but only if, on or before such date, the issuer made a public announcement of its intention to issue the debt and an offering circular or memorandum (including a preliminary offering circular or memorandum) with respect to the debt had been distributed to prospective investors, but only to the extent such debt is described in, and the amount of such debt does not exceed the aggregate the amount stated in, such offering circular or memorandum as of such date; or (7) issued before the 30th day after the date of enactment of this Act, as part of an issue substantially identical (other than yield) to an issue which was publicly announced as having been sold on December 7, 1995, but was terminated on such date.

Legislative Background

The proposal is substantially similar to the President's seven-year balanced budget proposal released on December 7, 1995.

15. Defer interest deduction on certain convertible debt

Present Law

Certain debt instruments contain a feature that allows the holder or the issuer, at certain future dates, to convert the instrument into shares of stock of the issuer or a related party. Some of these instruments may be issued at a discount and are convertible into a fixed number of shares of the issuer, regardless of the amount of original issue discount ("OID") accrued as of the date of conversion. Treasury regulations governing the accrual and deductibility of OID ignore options to convert a debt instrument into stock or debt of the issuer or a related party or into cash or other property having a value equal to the approximate value of such stock or debt (Treas. reg. sec. 1.1272-1(c)). Thus, OID on a convertible debt instrument generally is deductible as interest as such OID accrues, regardless of whether or not the debt is converted. The treatment of a holder of a discount instrument is similar to that of the issuer, i.e., a holder includes OID in income on an accrual basis.

Other convertible instruments may be issued with coupon interest, rather than OID, and may provide that if the debt is converted into stock, the holder does not receive any interest that accrued but was unpaid between the latest coupon date and the conversion date. Under present law, the issuer of such instrument generally cannot deduct such accrued but unpaid interest.[10]

Description of Proposal

The proposal would defer interest deductions on convertible debt until such time as the interest is paid. For this purpose, payment would not include: (1) the conversion of the debt into equity of the issuer or a related person (as determined under secs. 267(b) and 707(b)) or (2) the payment of cash or other property in an amount that is determined by reference to the amount of such equity. Convertible debt would include debt: (1) exchangeable into the stock of a party related to the issuer, (2) with cash-settlement conversion features, or (3) issued with warrants (or similar instruments) as part of an investment unit in which the debt instrument may be used to satisfy the exercise price of the warrant. Convertible debt would not include: (1) debt that is "convertible" because a fixed payment of principal or interest could be converted by the holder into equity of the issuer or a related party having a value equal to the amount of such principal or interest, or (2) any other debt specified by the Secretary of the Treasury. Holders of convertible debt would continue to include the interest on such instruments in gross income as under present law.

Effective Date

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[10] See, Rev. Rul. 74-127, 1974-1 C.B. 47 and Scott Paper v. Comm.,74 T.C. 137 (1980).

The proposal would be effective for debt issued on or after December 7, 1995. The proposal would not apply, however, to any debt instrument: (1) issued pursuant to a commitment that was binding before December 7, 1995; (2) issued pursuant to an exchange offer which was outstanding on such date; (3) which was priced for purposes of issuance on or before such date; (4) issued pursuant to a registration statement filed with the Securities and Exchange Commission ("SEC") on or before such date (other than a registration statement which, under 17 CFR 230.415, contemplated a delayed or continuous offering of such debt), but only to the extent that such debt is described in, and the amount of such debt does not exceed the aggregate the amount stated in, such registration statement as of such date; (5) issued pursuant to a registration statement filed with the SEC on or before such date and which, under 17 CFR 230.415, contemplated a delayed or continuous offering of such debt if a prospectus supplement (including a preliminary prospectus supplement) to such registration supplement was filed under 17 CFR 230.424 on or before such date, but only to the extent that such debt is described in, and the amount of such debt does not exceed the aggregate the amount stated in, such prospectus supplement as of such date (or, to the extent a preliminary prospectus supplement as of such date does not state a maximum amount to be issued, the amount expected to be offered may be established by other contemporaneous, written evidence); (6) issued pursuant to a private placement that contemplates resales of the instruments pursuant to 17 CFR 230.144A, but only if, on or before such date, the issuer made a public announcement of its intention to issue the debt and an offering circular or memorandum (including a preliminary offering circular or memorandum) with respect to the debt had been distributed to prospective investors, but only to the extent such debt is described in, and the amount of such debt does not exceed the aggregate the amount stated in, such offering circular or memorandum as of such date; or (7) issued before the 30th day after the date of enactment of this Act, as part of an issue substantially identical (other than yield) to an issue which was publicly announced as having been sold on December 7, 1995, but was terminated on such date.

Legislative Background

The proposal is substantially similar to a provision included in the President's seven-year balanced budget proposal released on December 7, 1995.

C. Foreign Tax Provisions

1. Modifications of rules relating to foreign trusts having one or more United States beneficiaries

Present Law

Income taxation of trusts and their beneficiaries

Taxation of trusts

A trust is treated as a separate taxable entity, except in cases where the grantor (or a person with a power to revoke the trust) has certain powers with respect to the trust (discussed below). A trust generally is taxed like an individual with certain modifications. These modifications include: (1) a separate tax rate schedule applicable to trusts; (2) an unlimited charitable deduction for amounts paid to charity; (3) a personal exemption of $300 for a trust that is required to distribute all of its income currently, or $100 for any other trust; (4) no standard deduction for trusts; and (5) a deduction for distributions to beneficiaries. A trust is required to use the calendar year as its taxable year. Trusts generally are required to pay estimated income tax.

Taxation of distributions to beneficiaries

Distributions from a trust to a beneficiary generally are includible in the beneficiary's gross income to the extent of the distributable net income ("DNI") of the trust for the taxable year ending with, or within, the taxable year of the beneficiary. DNI is taxable income (1) increased by any tax-exempt income (net of disallowed deductions attributable to such income), and (2) computed without regard to personal exemptions, the distribution deduction, capital gains that are allocated to corpus and are neither distributed to any beneficiary during the taxable year nor set aside for charitable purposes, capital losses other than capital losses taken into account in determining the amount of capital gains which are paid to beneficiaries, and (with respect to simple trusts) extraordinary dividends which are not distributed to beneficiaries (sec. 643). The exclusion for small business capital gains under section 1202 is not taken into account in determining DNI.

Distributions to trust beneficiaries out of previously accumulated income are taxed to the beneficiaries under a throwback rule (sec. 667). The effect of the throwback rule is to impose an additional tax on the distribution of previously accumulated income in the year of distribution at the beneficiary's average marginal rate for the 5 years prior to the distribution. The amount of the distribution is grossed-up by the amount of the taxes paid by the trust on the accumulated income and a nonrefundable credit is allowed to the beneficiary for such taxes. In order to prevent trusts from accumulating income for a year, the fiduciary of a trust may elect to treat distributions within the first 65 days after the close of its taxable year as having occurred at the end of the preceding taxable year.

If a trust makes a loan to one of its beneficiaries, the principal of such a loan is generally not taxable as income to the beneficiary.

Grantor trust rules

Under the grantor trust rules (secs. 671-679), the grantor of a trust will continue to be taxed as the owner of the trust (or a portion thereof) if it retains certain rights or powers. A grantor of a trust generally is treated as the owner of any portion of a trust when the following circumstances exist:

(1) The grantor has a reversionary interest that has more than a 5-percent probability of returning to the grantor.

(2) The grantor has power to control beneficial enjoyment of the income or corpus. Certain powers are disregarded for this purpose--(a) a power to apply income to support a dependent; (b) a power affecting beneficial enjoyment that can be exercised only after an event that has a 5 percent or less probability of occurring; (c) a power exercisable only by will; (d) a power to allocate among charities; (e) a power to distribute corpus under an ascertainable standard or as an advancement; (f) a power to withhold income temporarily; (g) a power to withhold income during disability; (h) a power to allocate between corpus and income; (i) a power to distribute, apportion, or accumulate income or corpus among a class of beneficiaries that is held by an independent trustee or trustees; and, (j) a power to distribute, apportion, or accumulate income among beneficiaries that is limited by an ascertainable standard.

(3) The grantor retains any of the following administrative powers--(a) a power to deal at non-arms' length; (b) a power to borrow trust funds without adequate interest or security; (c) a borrowing that extends over one taxable year; (d) a power to vote stock of a controlled corporation held in the trust; (e) a power to control investment of trust funds in a controlled corporation; or (f) a power to reacquire trust corpus by substituting property with equivalent value.

(4) The grantor has a power to revoke, unless such power may not be exercised any time before an event that has a 5-percent or less probability of occurring.

(5) The income is or may be distributed to, held for the future benefit of, or used to pay for life insurance on the lives of, the grantor or the grantor's spouse, unless such power may not be exercised any time before an event that has a 5-percent or less probability of occurring. (An exception is provided for income that may be used to discharge an obligation of support, unless the income is so used.)

If the grantor is not treated as the owner of any portion of a trust, another person generally will be treated as the owner of that portion of the trust if he or she has the power to revoke that portion of the trust or gave up a power to revoke and retained any of the powers set forth above, unless the retained power is disclaimed within a reasonable time.

Under the grantor trust rules, a U.S. person who transfers property to a foreign trust generally is treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary of any portion of the trust. This treatment generally does not apply, however, to transfers by reason of death, to sales or exchanges of property at fair market value where gain is recognized to the transferor, or to transfers made before the transferor became a U.S. person (sec. 679).

Under a special rule, intermediaries or nominees interposed between certain foreign trusts and their beneficiaries are disregarded. This special rule treats any amount paid from a foreign person to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust that was created by a U.S. person, as if paid to the recipient directly by the foreign trust (sec. 665(c)).

Under the grantor trust rules, a grantor generally is treated as the owner of the trust's assets without regard to whether the grantor is a domestic or foreign person. Under these rules, U.S. trust beneficiaries can avoid U.S. tax on distributions from a trust where a foreign grantor is treated as owner of the trust, even though no tax may be imposed on the trust income by any jurisdiction.[11]

A special rule applies in the case of a grantor trust with a U.S. beneficiary, where the grantor trust rules otherwise would treat a foreign person as the owner of a portion of the trust, and the U.S. beneficiary had made gifts at any time, directly or indirectly, to the foreign person. In such a case, the U.S. beneficiary generally is treated as the grantor and owner of that portion to the extent of the gifts to the foreign person (sec. 672(f)).

Foreign trusts that are not grantor trusts

In cases where the grantor trust rules do not apply to a foreign trust, its U.S. beneficiaries generally are taxable on their respective shares of the income of the trust that is required to be distributed, as well as any other income of the trust that is paid, credited, or distributed to them (secs. 652, 662). Distributions from a trust in excess of the trust's DNI[12] for the taxable year generally are treated as accumulation distributions (sec. 665(b)), subject to the throwback rules. Under these rules, a distribution by a foreign trust of previously accumulated income generally is taxed at the beneficiary's average marginal rate for the prior 5 years, plus interest (secs. 666, 667). Interest is computed at a fixed annual rate of 6 percent, with no compounding (sec. 668).

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[11] See Rev. Rul. 69-70, 1969-1 C.B. 182.

[12] In the case of a foreign trust, DNI also includes foreign-source income net of related deductions, income that is exempt under treaties, and capital gains reduced (but not below zero) by capital losses.

If adequate records of the trust are not available to determine the proper application of the rules relating to accumulation distributions to any distribution from a trust, the distribution is treated as an accumulation distribution out of income earned during the first year of the trust (sec. 666(d)).

Residence of estates and trusts

An estate or trust is treated as foreign if it is not subject to U.S. income taxation on its income that is neither derived from U.S. sources nor effectively connected with the conduct of a trade or business within the United States (sec. 7701(a)(31)). Thus, if a trust is taxed in a manner similar to a nonresident alien individual, it is considered to be a foreign trust. Any other estate or trust is treated as domestic (sec. 7701(a)(30)).

The Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien individual. Internal Revenue Service ("IRS") rulings and court cases, however, indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries.[13] If an examination of these factors indicates that a trust has sufficient foreign contacts, it is deemed comparable to a nonresident alien individual and, thus, is a foreign trust.

Section 1491 generally imposes a 35-percent excise tax on a U.S. person that transfers appreciated property to certain foreign entities, including a foreign trust.[14] In the case of a domestic trust that changes its situs and becomes a foreign trust, it is unclear whether property has been transferred from a U.S. person to a foreign entity, and, thus, whether the transfer is subject to section 1491.

Information reporting requirements and associated penalties

Any U.S. person who creates a foreign trust or transfers money or property to a foreign trust is required to report that event to the Treasury Department (sec. 6048(a)). Current regulations require reporting of, inter alia, the name, address and identification number (if any) of the transferor, the trust, the fiduciary and trust beneficiaries; the interest of each beneficiary; the location of the trust records; and the value of each item transferred (Treas. Reg. sec. 16.3-1(c)). Similarly, any U.S. person who transfers property to a foreign trust that has one or

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[13] For example, see Rev. Rul. 87-61, 1987-2 C.B. 219, Rev. Rul. 81-112, 1981-1 C.B. 598, Rev. Rul. 60-181, 1960-1 C.B. 257, and B.W. Jones Trust v. Commissioner, 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4th Cir. 1943).

[14] In Rev. Rul. 87-61 the IRS held that a U.S. citizen who transferred appreciated property to a foreign grantor trust is not subject to the section 1491 excise tax because the grantor continues to own the property for income tax purposes.

more U.S. beneficiaries is required to report annually to the Treasury Department (sec. 6048(c)). In addition, if the transfer of any appreciated property by a U.S. person is subject to section 1491, the transferor is required to report the transfer to the Treasury Department (Treas. Reg. sec. 1.1494-1(a)).

Any person who fails to file a required report with respect to the creation of, or a transfer to, a foreign trust may be subjected to a penalty of 5 percent of the amount transferred to the foreign trust (sec. 6677). Similarly, any person who fails to file a required annual report with respect to a foreign trust with U.S. beneficiaries may be subjected to a penalty of 5 percent of the value of the corpus of the trust at the close of the taxable year. The maximum amount of the penalty imposed under either case may not exceed $1,000. A reasonable cause exception is available. These civil penalties are determined separately from any applicable criminal penalties.

Description of Proposals

Overview

The proposals would modify certain aspects of the tax treatment of foreign trusts with U.S. beneficiaries as follows:

a. The grantor trust rules generally would apply only to the extent that they result, directly or indirectly, in amounts being currently taken into account in computing the income of a U.S. person. Certain exceptions would apply.

b. Beginning on January 1, 1996, the interest rate applicable to accumulation distributions from foreign nongrantor trusts would be the rate imposed on underpayment of tax under section 6621(a)(2), with compounding. The accumulation distribution generally would be allocated proportionately to prior trust years in which the trust had undistributed net income.

The full amount of a loan of cash or marketable securities by a foreign nongrantor trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such a grantor or beneficiary) would be treated as a distribution to the grantor or beneficiary. In addition, the value of the use of other trust property by the U.S. grantor, U.S. beneficiary (or a person related to such a grantor or beneficiary) as a distribution to the grantor or beneficiary in an amount equal to the fair market value of the use of the property.

c. A nonresident alien who transfers property to a foreign trust and then becomes a U.S. resident within 5 years after the transfer is treated as making a transfer to the foreign trust on his residency starting date. In determining whether a foreign trust paid fair market value to the transferor for property transferred to the trust, obligations issued by the trust, any person related to any grantor or beneficiary generally would not be taken into account.

d. A two-part objective test would be established for determining whether a trust is foreign or domestic for tax purposes. If both parts of the test are satisfied, the trust would be treated as domestic. Only the first part of the test would apply to estates.

e. The proposal would expand the reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The proposal would require the responsible parties to file the designated information reports with the Treasury Department upon the occurrence of certain events. A failure to comply with the reporting requirements would result in increased monetary penalties under the proposal. Unless a U.S. owner of any portion of a foreign trust appoints a limited agent to accept service of process with respect to requests and summons by the Treasury Department in connection with the tax treatment of items relating to the trust, special sanctions would apply.

f. Any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources totaling more than $10,000 during the year would be required to report the gift to the Treasury Department. Monetary penalties and certain sanctions would apply to a failure to comply with the reporting requirement.

The proposals are described in more detail below.

a. Inbound foreign grantor trust rules

Foreign grantors not treated as owners

Under the proposal, the grantor trust rules generally would apply only to the extent that they result, directly or indirectly, in amounts being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. Thus, the grantor trust rules generally would not apply to any portion of a trust where their effect would be to treat a foreign person as owner of that portion. The proposal would provide certain exceptions to this general rule. The proposal generally would not apply in the case of revocable trusts and trusts where the only amounts distributable during the lifetime of the grantor are to the grantor or the grantor's spouse. These exceptions would not apply to the extent of gifts made by a U.S. beneficiary of the trust to the foreign grantor. The proposal also would not apply to trusts established to pay compensation, and certain trusts in existence as of September 19, 1995.[15] In addition, the proposal generally would not apply where the grantor is a controlled foreign corporation, foreign personal holding company or passive foreign investment company.

In a case where the foreign grantor, who would be treated as the owner of the trust but for the above rule, actually pays tax on the income of the trust to a foreign country, it is anticipated that Treasury regulations would provide that U.S. beneficiaries who are subject to U.S. income

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[15] The exception would not apply to the portion of any such trust attributable to any transfers made after September 19, 1995.

tax on that income would be treated for foreign tax credit purposes as having paid the foreign taxes that were paid by the foreign grantor. Any resulting foreign tax credits would be subject to applicable foreign tax credit limitations.

The proposal would provide a transition rule for any domestic trust that has a foreign grantor who is treated as the owner of the trust under present law. If such a trust becomes a foreign trust before January 1, 1997, or if the assets of such a trust are transferred to a foreign trust before that date, such trust would be exempt from the excise tax on transfers to a foreign trust otherwise imposed by section 1491. However, the proposal's new reporting requirements and penalties would be applicable.

Distributions by foreign trusts through nominees

The proposal would treat any amount paid to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust of which the payor is not the grantor, as if paid by the foreign trust directly to the U.S. person. This rule would disregard the role of an intermediary or nominee that may be interposed between a foreign trust and a U.S. beneficiary. Unlike present law, however, the rule would apply whether or not the trust was created by a U.S. person. The rule would not apply to a withdrawal from a foreign trust by its grantor, with a subsequent gift or other payment to a U.S. person.

Effective date

The proposal would be effective on the date of enactment.

b. Foreign trusts that are not grantor trusts

Interest charge on accumulation distributions

The proposal would change the interest rate applicable to accumulation distributions from foreign trusts from simple interest at a fixed rate of 6 percent to compound interest determined in the manner of the interest imposed on underpayments of tax under section 6621(a)(2). Simple interest would continue to accrue at the rate of 6 percent through 1995. Beginning on January 1, 1996, however, compound interest based on the underpayment rate would be imposed not only on tax amounts determined under the accumulation distribution rules but also on the total simple interest for pre-1996 periods, if any. For purposes of computing the interest charge, the accumulation distribution would be allocated proportionately to prior trust years in which the trust had undistributed net income (and the beneficiary receiving the distribution was a U.S. citizen or resident), rather than to the earliest of such years. An accumulation distribution would be treated as reducing proportionately the undistributed net income from prior years.

The proposal would include an anti-abuse rule which authorizes the Secretary of the Treasury to issue regulations, on or after the date of enactment, that may be necessary or

appropriate to carry out the purposes of the rules applicable to accumulation distributions, including regulations to prevent the avoidance of those purposes.

Loans to grantors or beneficiaries and use of trust property

In the case of a loan of cash or marketable securities by the foreign trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such grantor or beneficiary[16]), the proposal would treat the full amount of the loan as distributed to the grantor or beneficiary, even if the loan bears interest at an adequate rate and is subsequently repaid. In addition, any subsequent transaction between the trust and the original borrower regarding the principal of the loan (e.g., repayment) would be disregarded for all purposes of the Code.

In the case of a use of other trust property, the proposal generally would treat the value of the use of such property by a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such grantor or beneficiary) as a distribution to the grantor or beneficiary in an amount equal to the fair market value of the use of the property.

Effective date

The proposal to modify the interest charge on accumulation distributions would apply to distributions after the date of enactment. The proposal with respect to loans to U.S. grantors or U.S. beneficiaries would apply to loans made after September 19, 1995. The proposal with respect to use of other trust property by U.S. grantors or U.S. beneficiaries would apply to transactions after December 31, 1995.

c. Outbound foreign grantor trust rules

The proposal would make several modifications to the rules of section 679 under which foreign trusts with U.S. grantors and U.S. beneficiaries are treated as grantor trusts.

Sale or exchange at market value

Present law contains an exception from grantor trust treatment for property transferred by a U.S. person to a foreign trust in the form of a sale or exchange at fair market value where gain is recognized to the transferor. In determining whether the trust paid fair market value to the transferor, the proposal would provide that obligations issued (or, to the extent provided by regulations, guaranteed) by the trust, by any grantor or beneficiary of the trust, or by any person related to a grantor or beneficiary generally would not be taken into account.

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[16] For this purpose, a person generally would be treated as related to the grantor or beneficiary if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under section 267 or 707(b).

Other transfers

Under the proposal, a transfer of property to certain charitable trusts would be exempt from the application of the rules treating foreign trusts with U.S. grantors and U.S. beneficiaries as grantor trusts.

Transferors or beneficiaries who become U.S. persons

The proposal would apply the rules of section 679 to certain foreign persons who transfer property to a foreign trust and subsequently become U.S. persons. A nonresident alien individual who transfers property, directly or indirectly, to a foreign trust and then becomes a resident of the United States within 5 years after the transfer generally would be treated as making a transfer to the foreign trust at the time the individual becomes a U.S. resident. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally would be treated under the rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. The proposal's new reporting requirements and penalties (discussed below) also would be applicable.

Under the proposal, a beneficiary would not be treated as a U.S. person for purposes of determining whether the transferor of property to a foreign trust would be taxed as a grantor with respect to any portion of a foreign trust if such beneficiary first became a U.S. resident more than 5 years after the transfer.

Treatment of former U.S. persons

The proposal would grant broad authority to the Treasury Secretary to treat any person who was a U.S. person at any time during the existence of the trust as a U.S. person in determining whether there are U.S. beneficiaries of the trust for purposes of section 679.

Outbound trust migrations

The proposal would apply the rules of section 679 to a U.S. person that transferred property to a domestic trust if the trust subsequently became a foreign trust while the transferor was still alive. Such a person would be deemed to make a transfer to the foreign trust on the date of the migration. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally would be treated under the rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. The proposal's reporting requirements and penalties (discussed below) also would be applicable.

Effective date

The proposals described in this part would apply to transfers of property after February 6, 1995.

d. Residence of estates and trusts

Treatment as U.S. person

The proposal would establish a two-part objective test for determining for tax purposes whether a trust is foreign or domestic. If both parts of the test are satisfied, the trust would be treated as domestic. Only the first part of the test would apply to estates.

Under the first part of the proposed test, in order for an estate or trust to be treated as domestic, a U.S. court (i.e., Federal, State, or local) must be able to exercise primary supervision over the administration of the estate or trust. It is expected that this test would be satisfied by any trust instrument that specifies that it is to be governed by the laws of any State. In addition, an estate or trust may be able to subject itself voluntarily to the jurisdiction of a U.S. court through registration of the estate or trust under a State law similar to Article VII of the American Law Institute's Uniform Probate Code.

Under the second part of the proposed test, in order for a trust to be treated as domestic, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust. It is expected that this test would be satisfied in any case where fiduciaries who are U.S. persons hold a majority of the fiduciary power (whether by vote or otherwise), and where no foreign fiduciary, such as a "trust protector" or other trust advisor, has the power to veto important decisions of the U.S. fiduciaries. It is further expected that, in applying this test, a reasonable period of time would be allowed for a trust to replace a U.S. fiduciary who resigns or dies before the trust would be treated as foreign.

Under the proposal, a foreign estate would be defined as an estate other than an estate that is determined to be domestic under the court-supervision test. A foreign trust would be defined as a trust other than a trust that is determined to be domestic under both the court-supervision test and the U.S. fiduciary test.

Outbound migration of domestic trusts

Under the proposal, if a domestic trust changes its situs and becomes a foreign trust, the trust would be treated as having made a transfer of its assets to the foreign trust and would be subject to the 35-percent excise tax imposed by present-law section 1491 unless one of the exceptions to this excise tax were applicable. The U.S. grantor also would be required to report the transfer under the reporting requirements described below. Failure to report such a transfer, or any transfer described in section 1491 (e.g., a transfer to a foreign partnership) would result in penalties (discussed below).

Effective date

The proposal to modify the treatment of a trust or estate as a U.S. person would apply to taxable years beginning after December 31, 1996. In addition, if the trustee of a trust so elects, the proposal would apply to taxable years ending after the date of enactment. The proposed amendment to section 1491 would be effective on the date of enactment.

e. Information reporting and penalties relating to foreign trusts

The proposal would expand the reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The proposal would require the responsible parties to file the designated information reports with the Treasury Department upon the occurrence of certain events. A failure to comply with the reporting requirements would result in increased monetary penalties under the proposal.

Information reporting requirements

First, the proposal would require the grantor, transferor or executor (i.e., the "responsible party") to notify the Treasury Department upon the occurrence of certain reportable events. The reportable events include direct and indirect transfers of property to a foreign trust and the death of a U.S. citizen or resident if any portion of a foreign trust was included in the gross estate of the decedent. The required notice would identify the money or other property transferred and report information regarding the trustee and beneficiaries of the foreign trust.

Second, a U.S. person that is treated as the owner of any portion of a foreign trust would be required to ensure that the trust files an annual report to provide full accounting of all the trust activities for the taxable year, the name of the U.S. agent for the trust, and other information as prescribed by the Secretary of the Treasury.[17] In addition, unless a U.S. person is authorized to accept service of process as the trust's limited agent with respect to any request by the Treasury Department to examine records or to take testimony and any summons for such records or testimony in connection with the tax treatment of any items related to the trust, the Treasury Secretary would be entitled to determine, in its sole discretion, the amount to be taken into account under the grantor trust rules (secs. 671 through 679). This limited agency relationship would not constitute an agency relationship for any other purpose under Federal or State law.

Third, any U.S. person who receives (directly or indirectly) any distribution from a foreign trust would be required to file a notice to report the name of the trust, the aggregate

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[17] It is intended that the regulations would require the trust to furnish information to U.S. grantors and beneficiaries concerning income reportable by such persons that is similar to the items on schedule K-1 of Form 1041.

amount of the distributions received, and other information that the Secretary of the Treasury may prescribe.

Monetary penalties for failure to report

Under the proposal, a person who fails to provide the required notice in cases involving the transfer of property to a new or existing foreign trust, or a distribution by a foreign trust to a U.S. person, would be subject to an initial penalty equal to 35 percent of the gross reportable amount. A failure to provide an annual reporting of trust activities would result in an initial penalty equal to 5 percent of the gross reportable amount. In cases involving a transfer of property to a foreign trust, the gross reportable amount would be the gross value of the property transferred. In cases involving the death of a U.S. citizen or resident whose estate includes any portion of a foreign trust, the gross amount would be the value of the property includible in the gross estate of the decedent. In cases where annual reporting of trust activities is required, the gross reportable amount would be the gross value of the portion of the foreign trust's assets treated as owned by the U.S. grantor at the close of the year, and in cases involving a distribution to a U.S. beneficiary of a foreign trust, the gross reportable amount would be the amount of the distribution to the beneficiary. An additional $10,000 penalty would be imposed for continued failure for each 30-day period (or fraction thereof) beginning 90 days after the Treasury Department notifies the responsible party of such failure. Such penalties would be subject to a reasonable cause exception.

Effective date

The reporting requirements and applicable penalties generally would apply to reportable events occurring or distributions received after the date of enactment. The annual reporting requirement and penalties applicable to U.S. grantors would apply to taxable years of such persons beginning after the date of enactment.

f. Reporting of certain foreign gifts

The proposal generally would require any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources totaling more than $10,000 during the taxable year to report them to the Treasury Department. The definition of a gift to a U.S. person for this purpose would exclude qualified tuition or medical payments made on behalf of the U.S. person, as defined for gift tax purposes (sec. 2503(e)(2)). If the U.S. person fails, without reasonable cause, to report foreign gifts as required, the Treasury Secretary would be authorized to determine, in its sole discretion, the tax treatment of the unreported gifts, based on information in its possession or as it may obtain. In addition, the U.S. person would be subject to a penalty equal to 5 percent of the amount of the gift for each month that the failure continues, with the total penalty not to exceed 25 percent of such amount.

Effective date.--The proposal would apply to amounts received after the date of enactment.

Legislative Background

The President's fiscal year 1996 budget proposal (referred to as the "1996 budget proposal") was submitted to the Congress on February 6, 1995. The 1996 budget proposal included amendments to the foreign trust provisions; such amendments were included in H.R. 981, introduced by Representatives Gephardt and Gibbons, and S. 453, introduced by Senators Moynihan and Daschle. Representative Gibbons and Senator Moynihan subsequently introduced identical bills, H.R. 2356 and S. 1261, on September 19, 1995. These subsequent bills revised the foreign trust amendments included in the 1996 budget proposal. The provisions of H.R. 2356 and S. 1261 are resubmitted as the foreign trust proposal described above. A substantially similar proposal was contained in the President's seven-year balanced budget proposal released on December 7, 1995.

The BBA of 1995 further modifies the provisions of H.R. 2356 and S. 1261. The following is a summary of the differences between the foreign trust proposal and the provisions of the BBA of 1995:

a. Inbound foreign grantor trust rules

The BBA of 1995 contains two technical corrections to the proposal with respect to the inbound foreign grantor trust rules.

The BBA of 1995 amends the grantor trust rules to apply in determining whether a foreign corporation is characterized as a passive foreign investment company ("PFIC"). Thus, a foreign corporation cannot avoid PFIC status by transferring its assets to a grantor trust.

Under the BBA of 1995, a U.S. beneficiary of an inbound grantor trust that transferred property to the foreign grantor by gift is treated as a grantor of a portion of the trust to the extent of the transfer. This rule applies without regard to whether the foreign grantor would otherwise be treated as the owner of any portion of such trust.

b. Foreign trusts that are not grantor trusts

Interest charge on accumulation distributions

The BBA of 1995 contains a technical correction to the proposal with respect to the accumulation distribution rules. Under the BBA of 1995, an accumulation distribution to a U.S. beneficiary of a foreign nongrantor trust is treated as reducing proportionately the undistributed net income for prior taxable years in which the trust had undistributed net income and the beneficiary receiving the distribution was a U.S. citizen or resident. In determining the interest payable with respect to a trust distribution, the distribution is deemed to be from years in which both such conditions are satisfied.

Use of trust property

The proposal generally would treat the value of the use of trust property (other than cash or marketable securities) by any U.S. grantor, U.S. beneficiary of the trust, or by a U.S. person related to such a grantor or beneficiary, as a distribution equal to the fair market value of the use of the property. The BBA of 1995 does not contain such a provision.

Loans to grantors or beneficiaries

The proposal would treat any loan of cash or marketable securities to any U.S. grantor or U.S. beneficiary of the trust, or to a U.S. person related to a such a grantor or beneficiary as a distribution by the trust. The BBA of 1995 grants the Treasury Secretary regulatory authority to exempt certain arm's-length loans from these rules.

c. Outbound foreign grantor trust rules

Sale or exchange at fair market value

The proposal would disregard all obligations issued by the trust, any grantor or beneficiary of the trust, or by anyone related to a grantor or beneficiary, in determining whether fair market value is provided in exchange for the property transferred. Thus, a U.S. person that transfers property to a foreign trust in exchange for such an obligation would be treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary, even if the obligation reflects a genuine indebtedness bearing a market rate of interest. The BBA of 1995 grants the Treasury Secretary regulatory authority to exempt certain arm's-length loans from these rules.

Treatment of former U.S. persons

The proposal would grant broad authority to the Treasury Secretary to treat anyone who was a U.S. person at any time during the existence of the trust as a U.S. person in determining whether there are U.S. beneficiaries of the trust for purposes of section 679. The BBA of 1995 does not contain such a provision.

d. Residence of estates and trusts

The proposal would impose reporting obligations and penalties for a failure to report on any outbound transfer subject to section 1491, even though the transaction does not involve a foreign trust (e.g., a transfer to a foreign partnership). The BBA of 1995 imposes reporting obligations and penalties for a failure to report only transfers involving a foreign trust (e.g., a transfer from a domestic trust to a foreign trust).

e. Information reporting relating to foreign trusts

Transfers to certain nonexempt trusts

The proposal would require the grantor, transferor, or executor to notify the Treasury Department upon the occurrence of certain reportable events: the creation of a foreign trust by a U.S. person, the transfer of money or property to a foreign trust by a U.S. person, and the death of a U.S. citizen or U.S. resident if any portion of a foreign trust was included in the gross estate of the decedent. The proposal would exclude from the definition of reportable events any such occurrence with respect to exempt pension trusts or certain charitable trusts. The BBA of 1995 excludes from the definition of reportable events any such occurrence with respect to a nonexempt employees' trust that is described in section 402(b).

Sanction for failure to appoint limited U.S. agent

Under the proposal, unless a U.S. person is authorized to accept service of process as the trust's limited agent with respect to any request by the Treasury Department to examine records or take testimony and any summons for such records or testimony in connection with the tax treatment of any items related to the trust, the Treasury Secretary would be entitled to determine, in its sole discretion, the amount to be taken into account under the grantor trust rules.

Under the BBA of 1995, the Treasury Secretary's exercise of its authority to make such a determination is subject to judicial review under an arbitrary or capricious standard, which accordingly provides a high degree of deference to such determination.

Sanction for failure to maintain adequate records

The BBA of 1995 contains a technical correction to the proposal regarding a U.S. distributee that fails to provide adequate records to the Treasury Department to determine the proper treatment of any distributions from a foreign trust. Under the BBA of 1995, if a U.S. distributee does not provide sufficient records, the accumulation distribution is deemed to come from the trust's average year (i.e., the number of years that the trust has been in existence divided by 2) for purposes of computing the interest charge applicable to such distribution.

Penalties for failure to report

The proposal would not provide a cap on penalties imposed for the failure to report certain transactions between a foreign trust and its U.S. grantor or U.S. beneficiary. Thus, the penalties could exceed the value of the property involved in the transaction. The BBA of 1995 limits the amount of monetary penalties to the gross reportable amount (i.e., generally the value of the property involved in the transaction).

f. Information reporting on foreign gifts

The proposal would not index for inflation the annual amount of gifts or bequests ($10,000) that are exempt from certain reporting requirements. Under the BBA of 1995, the $10,000 threshold for such reporting requirement is indexed for inflation.

2. Expand subpart F provisions regarding income from notional principal contracts and stock lending transactions

Present Law

Under the rules of subpart F, United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation ("CFC") are required to include in income currently certain types of income of the CFC, whether or not such income is distributed to the shareholders. The types of income subject to this current inclusion rule (generally referred to as "subpart F income") include, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consists of passive income in the following categories: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (a) property that gives rise to the foregoing types of income, (b) property that does not give rise to income, or (c) interests in a trust, partnership or REMIC; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. Income from a notional principal contract is treated as foreign personal holding company income only if such contract is referenced to commodities, foreign currency, interest rates, or to indices thereon. In addition, income derived from transfers of debt securities, but not equity securities, that are subject to the rules governing securities lending (sec. 1058) is treated as foreign personal holding company income.

A variety of exceptions from foreign personal holding company income are provided for income earned by a CFC that is a regular dealer in the property that is sold or exchanged, or income arising out of certain hedging transactions. However, no exception is available for a CFC that is a regular dealer with respect to financial instruments referenced to commodities.

Under section 956A, United States shareholders of a CFC are required to include in income currently their shares of the CFC's earnings invested in excess passive assets. A CFC generally has excess passive assets if its passive assets exceed 25 percent of its total assets. A passive asset is any asset that produces (or is held for the production of) passive income. For this purpose, passive income is generally defined as foreign personal holding company income.

Under section 1296, a foreign corporation is a passive foreign investment company ("PFIC") if the corporation satisfies either a passive income test or a passive asset test. Any U.S. person owning stock in a PFIC is subject to an interest charge with respect to certain distributions from the PFIC and gains on dispositions of the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes its share of the earnings

of the PFIC. For this purpose, passive income is defined by reference to foreign personal company income.

Description of Proposal

The proposal would add income from notional principal contracts as a new category of foreign personal holding company income. In addition, dividend equivalent payments (i.e., in-lieu-of dividend payments made pursuant to a securities lending transaction that qualifies under sec. 1058) would be added as another category of foreign personal holding company income.

Foreign personal holding company income would be computed without regard to income, gain, deduction or loss from any transaction (including hedging transactions) entered into in the ordinary course of a CFC's business as a dealer in property, notional principal contracts, forward contracts, options and similar financial instruments (including instruments referenced to commodities).

Under the proposal, income, gain, deduction or loss from a notional principal contract entered into to hedge an item of income in a category of foreign personal holding company income, other than dividends, interest, royalties, rents, annuities or dividend equivalent payments, would be allocated to that category.

Foreign personal holding company income from notional principal contracts and transfers of equity securities that are subject to the rules governing securities lending transactions (sec. 1058) would constitute passive income for purposes of determining whether a foreign corporation is a PFIC. The notional principal contracts and equity securities subject to section 1058 that give rise to foreign personal holding company income under the proposal would constitute passive assets for purposes of sections 956A and the PFIC provisions.

Effective Date

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

Legislative Background

A substantially similar proposal was contained in the President's seven-year balanced budget proposal released on December 7, 1995.

3. Treatment of foreign oil and gas extraction income

Present Law

A credit against U.S. tax on foreign income is allowed for foreign taxes paid by a U.S. person. The foreign tax credit is available only for income, war profits, and excess profits taxes paid or accrued (or deemed paid) to a foreign country or a U.S. possession and for certain taxes

imposed in lieu of such taxes (secs. 901 and 903). Other foreign levies generally are treated as deductible expenses only. To be creditable, a foreign tax must be the substantial equivalent of an income tax in the U.S. sense, whatever the foreign government that imposes it may call it. Under a special limitation, amounts claimed by a U.S. corporation as taxes paid on foreign oil and gas extraction income constitute creditable taxes (provided that such amounts otherwise qualify as creditable) only to the extent that they do not exceed 35 percent (i.e., the highest U.S. corporate tax rate) of such extraction income (sec. 907(a)).

The amount of foreign tax credits that can be claimed in a year is subject to an overall limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. income. The limitation is calculated by prorating the taxpayer's pre-credit U.S. tax on its worldwide taxable income between its U.S. source taxable income and its foreign source taxable income. The foreign tax credit limitation is calculated separately for specific categories of income.

Foreign corporations generally are not subject to U.S. tax on their foreign source income. Absent applicable anti-deferral rules, a U.S. investor in a foreign corporation is subject to U.S. tax on the income of the foreign corporation when such income is distributed to him or her. However, anti-deferral rules apply with respect to the income of certain U.S.-owned foreign corporations (e.g., controlled foreign corporations, passive foreign investment companies, or foreign personal holding companies). Under the subpart F rules (secs. 951-964), the U.S. 10-percent shareholders of a controlled foreign corporation are subject to U.S. tax currently on their shares of certain income earned by the corporation (i.e., subpart F income).

Subpart F income includes foreign base company oil related income (sec. 954(g)). Foreign base company oil related income generally is foreign oil related income other than income derived from a source within a foreign country in connection with (1) oil or gas which was extracted from an oil or gas well located in such foreign country, or (2) oil, gas, or a primary product of oil or gas which is sold by the foreign corporation or a related person for use or consumption within such country or is loaded in such country on a vessel or aircraft as fuel for such vessel or aircraft. Foreign base company oil related income does not include income of small oil producers (i.e., corporations whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

Description of Proposal

The proposal would deny the foreign tax credit with respect to all income, war profits, or excess profits taxes paid or accrued (or deemed paid) to any country which are attributable to foreign oil and gas extraction income. In addition, under the proposal, foreign oil and gas extraction income would not be taken into account in applying the foreign tax credit limitation. The proposal also would treat foreign oil and gas extraction income as foreign base company oil related income which is subject to current U.S. taxation under the rules of subpart F (without regard to the exceptions contained in sec. 954(g)). Finally, the proposal would apply notwithstanding any treaty obligation of the United States.

Effective Date

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

4. Repeal of exclusion of earned income of citizens or residents of the United States living abroad

Present Law

Under section 911, qualified individuals who reside outside the United States generally are entitled to exclude from gross income for U.S. tax purposes up to $70,000 of their foreign earned income. Furthermore, qualified individuals may elect to exclude from gross income, or in some cases deduct from gross income, certain of their housing expenses.

Description of Proposal

The proposal would repeal the exclusion for foreign earned income and the exclusion or deduction for housing expenses under section 911.

Effective Date

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

D. Accounting Provisions

1. Treatment of bad debt deductions of thrift institutions

Present Law and Background

Reserve method of accounting for bad debts of thrift institutions

Generally, a taxpayer engaged in a trade or business may deduct the amount of any debt that becomes wholly or partially worthless during the year (the "specific charge-off" method of sec. 166). Certain thrift institutions (building and loan associations, mutual savings banks, or cooperative banks) are allowed deductions for bad debts under rules more favorable than those granted to other taxpayers (and more favorable than the rules applicable to other financial institutions). Qualified thrift institutions may compute deductions for bad debts using either the specific charge-off method or the reserve method of section 593. To qualify for this reserve method, a thrift institution must meet an asset test, requiring that 60 percent of its assets consist of "qualifying assets" (generally cash, government obligations, and loans secured by residential real property). This percentage must be computed at the close of the taxable year, or at the option of the taxpayer, as the annual average of monthly, quarterly, or semiannual computations of similar percentages.

If a thrift institution uses the reserve method of accounting, it must establish and maintain a reserve for bad debts and charge actual losses against the reserve, and is allowed a deduction for annual additions to restore the reserve to its permitted balance. Under section 593, a thrift institution annually may elect to calculate its addition to its bad debt reserve under either (1) the "percentage of taxable income" method applicable only to thrift institutions, or (2) the "experience" method that also is available to small banks.

Under the "percentage of taxable income" method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to 8 percent of its taxable income (determined without regard to this deduction and with additional adjustments). Under the experience method, a thrift institution generally is allowed a deduction for an addition to its bad debt reserve equal to the greater of: (1) an amount based on its actual average experience for losses in the current and five preceding taxable years, or (2) an amount necessary to restore the reserve to its balance as of the close of the base year. For taxable years beginning before 1988, the "base year" was the last taxable year before the most recent adoption of the experience method (i.e., generally, the last year the taxpayer was on the percentage of taxable income method). For taxable years beginning after 1987, the base year is the last taxable year beginning before 1988. Prior to 1988, computing bad debts under a "base year" rule allowed a thrift institution to claim a deduction for bad debts for an amount at least equal to the institution's actual losses that were incurred during the taxable year.

Bad debt methods of commercial banks

A small commercial bank (i.e., one with adjusted bases of assets of $500 million or less) may use the experience method or the specific charge-off method for purposes of computing its deduction for bad debts. A large commercial bank only may use the specific charge-off method of section 166. If a small bank becomes a large bank, it must recapture its existing bad debt reserve (i.e., include the amount of the reserve in income) through one of two elective methods. Under the 4-year recapture method, the bank generally includes 10 percent of the reserve in income in the first taxable year, 20 percent in the second year, 30 percent in the third year, and 40 percent in the fourth year. Under the cut-off method, the bank generally neither restores its bad debt reserve to income nor may it deduct losses relating to loans held by the bank as of the date of the required change in the method of accounting. Rather, the amount of such losses are charged against and reduce the existing bad debt reserve; any losses in excess of the reserve are deductible. Any reserve balance in excess of the balance of related loans is includible in income.

Recapture of bad debt reserves by thrift institutions

If a thrift institution becomes a commercial bank, or if the institution fails to satisfy the 60-percent qualified asset test, it is required to change its method of accounting for bad debts and, under proposed Treasury regulations,[18] is required to recapture its bad debt reserve. The percentage-of-taxable-income portion of the reserve generally is included in income ratably over a 6-taxable year period. The experience method portion of the reserve is not restored to income if the former thrift institution qualifies as a small bank. If the former thrift institution is treated as a large bank, the experience method portion of the reserve is restored to income ratably over a 6-taxable year period, or under the 4-year recapture method or the cut-off method described above.

In addition, a thrift institution may be subject to a form of reserve recapture even if the institution continues to qualify for the percentage of taxable income method. Specifically, if a thrift institution distributes to its shareholders an amount in excess of its post-1951 earnings and profits, such excess is deemed to be distributed from the institution's bad debt reserve and is restored to income. In the case of any distribution in redemption of stock or in partial or complete liquidation of an institution, the distribution is treated as first coming out of the bad debt reserves of the institution (sec. 593(e)).

Financial accounting treatment of tax reserves of bad debts of thrift institutions

In general, for financial accounting purposes, a corporation must record a deferred tax liability with respect to items that are deductible for tax purposes in a period earlier than they are expensed for book purposes. The deferred tax liability signifies that, although a corporation may be reducing its current tax expense because of the accelerated tax deduction, the corporation will

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[18] Prop. Treas. reg. sec. 1.593-13.

become liable for tax in a future period when the timing item "reverses" (i.e., when the item is expensed for book purposes but for which the tax deduction had already been allowed). Under the applicable accounting standard (Accounting Principles Board Opinion 23), deferred tax liabilities generally were not required for pre-1988 tax deductions attributable to the bad debt reserve method of thrift institutions because the potential reversal of the bad debt reserve was indefinite (i.e., generally, a reversal only would occur by operation of sec. 593(e), a condition within the control of a thrift institution). However, the establishment of 1987 as a base year increased the likelihood of bad debt reserve reversals with respect to post-1987 additions to the reserve and the conferees understand that thrift institutions generally have recorded deferred tax liabilities for these additions under the current generally accepted accounting principles.

Description of Proposal

Repeal of section 593

The proposal would repeal the section 593 reserve method of accounting for bad debts by thrift institutions, effective for taxable years beginning after 1995. Under the proposal, thrift institutions that qualify as small banks would be allowed to utilize the experience method applicable to such institutions, while thrift institutions that are treated as large banks are required to use only the specific charge-off method.

Treatment of recapture of bad debt reserves

In general

A thrift institution required to change its method of computing reserves for bad debts would treat such change as a change in a method of accounting, initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury. Any section 481(a) adjustment required to be taken into account with respect to such change generally would be determined solely with respect to the "applicable excess reserves" of the taxpayer. The amount of applicable excess reserves would be taken into account ratably over a 6-taxable year period, beginning with the first taxable year beginning after 1995, subject to the residential loan requirement described below. In the case of a thrift institution that becomes a "large bank" (as determined under sec. 585(c)(2)), the amount of the institution's applicable excess reserves will be the excess of (1) the balance of its reserves described in section 593(c)(1) (i.e., its supplemental reserve for losses on loans, its reserve for losses on qualifying real property loans, and its reserve for losses on nonqualifying loans) as of the close of its last taxable year beginning before January 1, 1996, over (2) the balance of such reserves as of the close of its last taxable year beginning before January 1, 1988 (i.e., the "pre-1988 reserves"). Similar rules would be provided for "small banks" and for small banks that subsequently become large banks.

The balance of the pre-1988 reserves would continue to be subject to the provisions of present-law section 593(e) (requiring recapture in the case of certain excess distributions to, and redemptions of, shareholders).

Residential loan requirement

Under a special rule, if the taxpayer meets the "residential loan requirement" for a taxable year, the recapture of the applicable excess reserves otherwise required to be taken into account as a section 481(a) adjustment for such year would be suspended. A taxpayer would meet the residential loan requirement if, for the taxable year, the principal amount of residential loans made by the taxpayer during the year is not less than its base amount. The residential loan requirement would be applicable only for taxable years that begin after December 31, 1995, and before January 1, 1998, and must be applied separately with respect to each such year. Thus, all taxpayers would be required to recapture their applicable excess reserves within six, seven, or eight years after the effective date of the provision.

The "base amount" of a taxpayer would mean the average of the principal amounts of the residential loans made by the taxpayer during the six most recent taxable years beginning before January 1, 1996. At the election of the taxpayer, the base amount may be computed by disregarding the taxable years within that 6-year period in which the principal amounts of loans made during such years were highest and lowest. The test would be applied on a controlled group basis. The balance of a taxpayer's applicable excess reserve would be treated as a tax attribute to which section 381 applies. Thus, if an institution with an applicable excess reserve is acquired in a tax-free reorganization, the balance of such reserve would not be immediately restored to income but will continue to be subject to the residential loan requirement in the hands of the acquirer.

Effective Date

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

Legislative Background

The proposal is identical to a provision in the BBA of 1995 and a provision in the President's seven-year balanced budget proposal released on December 7, 1995.

2. Reform depreciation under the income forecast method

Present Law

Depreciation and amortization, in general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through allowances for depreciation or amortization. Depreciation deductions are allowed under section 167 and the amounts of such deductions are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168 for most tangible property. MACRS determines depreciation by applying specific recovery periods,

placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Intangible property generally is amortized under section 197, which applies a 15-year recovery period and the straight-line method to the cost of applicable property.

Treatment of film, video tape, and similar property

MACRS does not apply to certain property, including (1) any motion picture film, video tape, or sound recording or (2) any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. Likewise, section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property unless acquired as part of a trade or business. Thus, the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the general depreciation provision of section 167, which allows deductions for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property.

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

In the case of a film, income to be taken into account under the income forecast method means income from the film less the expense of distributing the film, including estimated income from foreign distribution or other exploitation of the film. In the case of a motion picture released for theatrical exhibition, income does not include estimated income from future television exhibition of the film (unless an arrangement for domestic television exhibition has been entered into before the film has been depreciated to its reasonable salvage value). In the case of a series or a motion picture produced for television exhibition, income does not include

estimated income from domestic syndication of the series or the film (unless an arrangement for syndication has been entered into before the series or film has been depreciated to its reasonable salvage value). The Internal Revenue Service also has ruled that income does not include net merchandising revenue received from the exploitation of film characters.

Description of Proposal

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

First, the proposal would provide that income to be taken into account under the income forecast method includes all estimated income generated by the property. In applying this rule, a taxpayer generally need not take into account income expected to be generated more than ten years after the year the property was placed in service. In addition, pursuant to a special rule, in the case of television and motion picture films, the income from the property shall include income from the exploitation of characters, designs, scripts, scores, and other incidental income associated with such films, but only to the extent the income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related to the taxpayer (within the meaning of sec. 267(b)). Finally, pursuant to another special rule, if a taxpayer produces a television series and initially does not anticipate syndicating the episodes from the series, the forecasted income for the episodes of the first three years of the series need not take into account any future syndication fees (unless the taxpayer enters into an arrangement to syndicate such episodes during such period). The 10-year rule, the character exploitation rule, and the syndication rule would apply for purposes of the look-back method described below.

In addition, the cost of property subject to depreciation would only include amounts that satisfy the economic performance standard of section 461(h). Except as provided in regulations, any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.

Finally, taxpayers that claim depreciation deductions under the income forecast method would be required to pay (or would receive) interest based on the recalculation of depreciation under a "look-back" method. The "look-back" method would be applied in any "recomputation year" by: (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in regulations, a "recomputation year" would be the third and tenth taxable year after the taxable year the property was placed in service unless the actual income from the property for each period before the close of such years was within 10 percent of the estimated income from the property for such periods. The Secretary of the Treasury would have the authority to allow a taxpayer to delay the initial application of the look-back method where the taxpayer may be expected to have significant income from the property after the third taxable year after the taxable year the property was placed in service

(e.g., the Secretary may exercise such authority where the depreciable life of the property is expected to be longer than three years). Property with an adjusted basis of $100,000 or less when the property was placed in service would not be subject to the look-back method. The proposal would provide a simplified look-back method for pass-through entities.

Effective Date

The proposal would be effective for property placed in service after September 13, 1995, unless placed in service pursuant to a binding written contract in effect before such date and all times thereafter.

Legislative Background

The proposal is substantially identical to a provision contained in the BBA of 1995 and a proposal contained in the President's seven-year balanced budget proposal released on December 7, 1995.

3. Repeal of lower-of-cost-or-market method of accounting for inventory

Present Law

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the "first-in-first-out" ("FIFO") method which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the "last-in-first-out" ("LIFO") method which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

Treasury regulations provide that taxpayers that maintain inventories under the FIFO method may determine the value of ending inventory under a (1) cost method or (2) "lower of cost or market" ("LCM") method (Treas. reg. sec. 1.471-2(c)). Under the LCM method, the value of ending inventory is written down if its market value is less than its cost. Similarly, any goods that are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of stye, odd or broken lots, or other similar causes, may be written down to net selling price.

Retail merchants may use the "retail method" in valuing ending inventory. Under the retail method, the total of the retail selling prices of goods on hand at yearend is reduced to approximate cost by deducting an amount that represents the gross profit embedded in the retail

prices. The amount of the reduction generally is determined by multiplying the retail price of goods available at yearend by a fraction, the numerator of which is the cost of goods available for sale during the year and the denominator of which is the total retail selling prices of the goods available for sale during the year, with adjustments for mark-ups and mark-downs (Treas. reg. sec. 1.471-8(a)). Under certain conditions, a taxpayer using the FIFO method need not take into account retail price mark-downs in determining the retail price of the goods available for sale during the year (Treas. reg. sec. 1.471-8(d)). As a result, such taxpayer may write-down the value of inventory below both its cost and its market value.

Description of Proposal

The proposal would repeal the LCM method and the write-down of unsalable goods. In addition, the proposal would require taxpayers that use the retail method of valuing inventory to take mark-downs into account in determining the approximate cost of inventory. Appropriate wash-sale rules would be provided. The proposal would not apply to taxpayers with average annual gross receipts over a three-year period of $5 million or less.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1998. Any section 481(a) adjustment required to be taken into account pursuant to the change of method of accounting under the proposal would be taken into account ratably over four taxable years beginning with the first taxable year beginning after December 31, 1998.

Legislative Background

The proposal is substantially similar to a provision that had been reported favorably by the Senate Committee on Finance in conjunction with the passage of the General Agreement on Tariffs and Trade, but was not included in the final legislation as passed by the Congress in 1994. The proposal also is substantially similar to a provision contained in the President's seven-year balanced budget proposal that was released on December 7, 1995. The proposal released on December 7, 1995, would have been effective for taxable years beginning after December 31, 1995, rather than taxable years beginning after December 31, 1998.

E. Administrative Provisions

1. Repeal advance refunds of diesel fuel tax to purchasers of diesel-powered automobiles, vans, and light trucks

Present Law

Excise taxes are imposed on gasoline (14 cents per gallon) and diesel fuel (20 cents per gallon) to fund the Federal Highway Trust Fund. Before 1985, the gasoline and diesel fuel tax rates were the same. The predominate highway use of diesel fuel is by trucks. In 1984, the diesel excise tax rate was increased above the gasoline tax as the revenue offset for a reduction in the annual heavy truck use tax. Because automobiles, vans, and light trucks, did not benefit from the use tax reductions, a provision was enacted allowing first purchasers of model year 1979 and later diesel-powered automobiles, vans, and light trucks a tax credit to offset this increased diesel fuel tax. The credit is $102 for automobiles, and $198 for vans and light trucks.

Description of Proposal

The tax credit for purchasers of diesel-powered automobiles, vans, and light trucks would be repealed.

Effective Date

The proposal would be effective for vehicles purchased after December 31, 1995.

Legislative Background

This proposal is included in the BBA of 1995 and in the President's seven-year balanced budget proposal released on December 7, 1995.

2. Increase penalties for failure to file correct information returns

Present Law

Any person that fails to file a correct information return with the IRS on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed. If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return after the date that is after 30 days after the prescribed filing date but on or before August 1 of that year, the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct information return is not filed on or before August 1, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year.

There is a special rule for de minimis failures to include the required, correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) ten returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

In addition, there are special, lower maximum levels for this penalty for small businesses. For this purpose, a small business is any person having average annual gross receipts for the most recent three taxable years ending before the calendar year that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

If a failure to file a correct information return with the IRS is due to intentional disregard of the filing requirement, the penalty for each such failure is generally increased to the greater of $100 or ten percent of the amount required to be reported correctly, with no limitation on the maximum penalty per calendar year (sec. 6721(e)). The increase in the penalty applies regardless of whether a corrected information return is filed, the failure is de minimis, or the person subject to the penalty is a small business.

Description of Proposal

The proposal would increase the penalty for failure to file information returns correctly on or before August 1 from $50 for each return to the greater of $50 or five percent of the amount required to be reported correctly but no so reported. The $250,000 maximum penalty for failure to file correct information returns during any calendar year ($100,000 with respect to small businesses) would continue to apply under the proposal.

The proposal also would provide for an exception to this increase where substantial compliance has occurred. The proposal would provide that this exception would apply with respect to a calendar year if the aggregate amount that is timely and correctly reported for that calendar year is at least 97 percent of the aggregate amount required to be reported under that section of the Code for that calendar year. If this exception applies, the present-law penalty of $50 for each return would continue to apply.

The proposal would not affect the following provisions of present law: (1) the reduction in the $50 penalty where correction is made within a specified period; (2) the exception for de minimis failures; (3) the lower limitations for persons with gross receipts of not more than $5,000,000; (4) the increase in the penalty in cases of intentional disregard of the filing requirement; (5) the penalty for failure to furnish correct payee statements under section 6722;

(6) the penalty for failure to comply with other information reporting requirements under section 6723; and (7) the reasonable cause and other special rules under section 6724.

Effective Date

The proposal would apply to information returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

Legislative Background

An identical proposal is contained in the President's seven-year balanced budget proposal released on December 7, 1995. A similar but narrower proposal was contained in the Health Security Act (sec. 11602 of H.R. 3600, as passed by the House of Representatives, 103d Congress). That proposal applied only to returns relating to payments for services under either section 6041 or section 6041A.

F. Casualty and Involuntary Conversion Provision

1. Basis adjustment to property held by a corporation where stock in corporation is replacement property under involuntary conversion rules (sec. 1033)

Present Law

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

Description of Proposal

The proposal would provide that where the taxpayer satisfies the replacement property requirement by acquiring stock in a corporation, the corporation generally would reduce its adjusted bases in its assets by the amount by which the taxpayer reduces its basis in the stock. The corporation's adjusted bases in its assets would not be reduced, in the aggregate, below the taxpayer's basis in its stock (determined after the appropriate basis adjustment for the stock). In addition, the basis of any individual asset would not be reduced below zero. The basis reduction would be first applied to property that is similar or related in service or use to the converted property, then to other depreciable property, and finally to any other property.

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

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

Example 2.--Assume the same facts as in Example 1, except that on the date of acquisition, the corporation has an adjusted basis of $100,000 (rather than $1 million) in the building. Under the proposal, the taxpayer would reduce his or her basis in the stock to

$100,000 (as under present law) and the corporation would not be required to reduce its adjusted basis in the building.

Effective Date

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

Legislative Background

The proposal is identical to a provision in the BBA of 1995 and a provision in the President's seven-year balanced budget proposal released on December 7, 1995.

G. Excise Tax on Amounts of Private Excess Benefits

Present Law

Private inurement

Charities.--Section 501(c)(3) specifically conditions tax-exempt status for all organizations described in that section on the requirement that no part of the net earnings of the organization inures to the benefit of any private shareholder or individual (the so-called "private inurement test").

Social welfare organizations.--A tax-exempt social welfare organization described in section 501(c)(4) must be organized on a non-profit basis and must be operated exclusively for the promotion of social welfare. In contrast to section 501(c)(3), however, there is no specific statutory rule in section 501(c)(4) prohibiting the net earnings of a social welfare organization described in section 501(c)(4) from inuring to the benefit of a private shareholder or individual.[19]

Other organizations.--Other tax-exempt organizations, such as labor and agricultural organizations described in section 501(c)(5) and business leagues described in section 501(c)(6) are subject to the private inurement test, as a result of explicit statutory language or Treasury Department regulations.

Sanctions for private inurement and other violations of exemption standards

Organizations described in section 501(c)(3) are classified as either public charities or private foundations. Penalty excise taxes may be imposed under the Code when a public charity makes political expenditures (sec. 4955) or excessive lobbying expenditures (secs. 4911 and 4912). However, the Code generally does not provide for the imposition of penalty excise taxes in cases where a 501(c)(3) public charity or a section 501(c)(4) social welfare organization engages in a transaction that results in private inurement. In such cases, the only sanction that specifically is authorized under the Code is revocation of the organization's tax-exempt status. A transaction engaged in by a private foundation (but not a public charity) is subject to special penalty excise taxes under the Code if the transaction is a prohibited "self-dealing" transaction (sec. 4941) or does not accomplish a charitable purpose (sec. 4945).

Filing and public disclosure rules

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[19] Even where no prohibited private inurement exists, however, more than incidental private benefits conferred on individuals may result in the organization not being operated "exclusively" for an exempt purpose. See, e.g., American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989).

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return (Form 990) with the Internal Revenue Service ("IRS"), setting forth the organization's items of gross income and expenses attributable to such income, disbursements for tax-exempt purposes, plus certain other information for the taxable year. Private foundations are required to allow public inspection at the foundation's principal office of their current annual information return. Other tax-exempt organizations, including public charities, are required to allow public inspection at the organization's principal office (and certain regional or district offices) of their annual information returns for the three most recent taxable years (sec. 6104(e)). The Code also requires that tax-exempt organizations allow public inspection of the organization's application to the IRS for recognition of tax-exempt status, the IRS determination letter, and certain related documents. In addition, upon written request to the IRS, members of the general public are permitted to inspect annual information returns of tax-exempt organizations and applications for recognition of tax-exempt status (and related documents) at the National Office of the IRS in Washington, D.C. A person making such a written request is notified by the IRS when the material is available for inspection at the National Office, where notes may be taken of the material open for inspection, photographs taken with the person's own equipment, or copies of such material obtained from the IRS for a fee (Treas. Reg. secs. 301.6104(a)-6 and 301.6104(b)-1).

Section 6652(c)(1)(A) provides that a tax-exempt organization that fails to file a complete and accurate Form 990 is subject to a penalty of $10 for each day during which such failure continues (with a maximum penalty with respect to any one return of the lesser of $5,000 or five percent of the organization's gross receipts for the year). Section 6652(c)(1)(C) provides that tax-exempt organizations that fail to make certain annual returns and applications for exemption available for public inspection are subject to a penalty of $10 for each day the failure continues (with a maximum penalty with respect to any one return not to exceed $5,000, and without limitation with respect to applications). In addition, section 6685 provides a penalty for willfully failing to make an annual return or application available for public inspection of $1,000 per return or application.

Organizations that have tax-exempt status but that are not eligible to receive tax-deductible charitable contributions are required expressly to state in certain fundraising solicitations that contributions or gifts to the organization are not deductible as charitable contributions for Federal income tax purposes (sec. 6113). Penalties may be imposed on such organizations for failure to comply with this requirement (sec. 6710).

Description of Proposal

Extend private inurement prohibition to social welfare organizations

The proposal would amend section 501(c)(4) explicitly to provide that a social welfare organization or other organization described in that section would be eligible for tax-exempt status only if no part of its net earnings inures to the benefit of any private shareholder or individual.

In addition, the proposal would provide that the private inurement rule will not be violated solely because of an allocation or return of net margins or capital to the members of a nonprofit association or organization that operates on a cooperative basis in accordance with its incorporating statute and bylaws (substantially as in existence on the date of enactment) and was determined to be exempt from Federal income tax under section 501(c)(4) prior to the date of enactment. However, such cooperative organizations would be subject to the general private inurement proscription with respect to any other type of transaction.

Effective date.--This provision generally would be effective on September 14, 1995. However, under a special transition rule, the provision would not apply to inurement occurring prior to January 1, 1997, if such inurement results from a written contract that was binding on September 13, 1995, and at all times thereafter before such inurement occurred, and the terms of which have not materially changed.

Intermediate sanctions for excess benefit transactions

The proposal would impose penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under section 501(c)(3) or 501(c)(4) (other than private foundations, which are subject to a separate penalty regime under current law) engage in an "excess benefit transaction." In such cases, intermediate sanctions could be imposed on certain disqualified persons (i.e., insiders) who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper.

An "excess benefit transaction" would be defined as: (1) any transaction in which an economic benefit is provided to, or for the use of, any disqualified person if the value of the economic benefit provided directly by the organization (or indirectly through a controlled entity[20]) to such person exceeds the value of consideration (including performance of services) received by the organization for providing such benefit; and (2) to the extent provided in Treasury Department regulations, any transaction in which the amount of any economic benefit provided to, or for the use of, any disqualified person is determined in whole or in part by the revenues of the organization, provided that the transaction constitutes prohibited inurement under present-law section 501(c)(3) or under section 501(c)(4), as amended. Thus, "excess benefit transactions" subject to excise taxes would include transactions in which a disqualified person engages in a non-fair-market-value transaction with an organization or receives unreasonable compensation, as well as financial arrangements (to the extent provided in Treasury regulations) under which a disqualified person receives payment based on the

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[20] A tax-exempt organization could not avoid the private inurement proscription by causing a controlled entity to engage in an excess benefit transaction. Thus, for example, if a tax-exempt organization causes its taxable subsidiary to pay excessive compensation to an individual who is a disqualified person with respect to the parent organization, such transaction would be an excess benefit transaction.

organization's income in a transaction that violates the present-law private inurement prohibition. The Treasury Department would be instructed to issue prompt guidance providing examples of revenue-sharing arrangements that violate the private inurement prohibition, and such guidance would be applicable on a prospective basis.[21]

Existing tax-law standards (see sec. 162) would apply in determining reasonableness of compensation and fair market value. In applying such standards, it is intended that the parties to a transaction would be entitled to rely on a rebuttable presumption of reasonableness with respect to a compensation arrangement with a disqualified person if such arrangement was approved by an independent board (or an independent committee authorized by the board) that: (1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement; (2) obtained and relied upon appropriate data as to comparability (e.g., compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys by nationally recognized independent firms; or actual written offers from similar institutions competing for the services of the disqualified person); and (3) adequately documented the basis for its determination (e.g., the record includes an evaluation of the individual whose compensation was being established and the basis for determining that the individual's compensation was reasonable in light of that evaluation and data).[22] If these three criteria are satisfied, penalty excise taxes could be imposed under the proposal only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction (e.g., the IRS could establish that the compensation data relied upon by the parties was not for functionally comparable positions or that the disqualified person, in fact, did not substantially perform the responsibilities of such position). A similar rebuttable presumption would arise with respect to the reasonableness of the valuation of property sold or otherwise transferred (or purchased) by an organization to (or from) a disqualified person if the sale or transfer (or purchase) is approved by an independent board that uses appropriate comparability data and adequately documents its determination. The Secretary of the Treasury

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[21] Under present law, certain revenue sharing arrangements have been determined not to constitute private inurement (see e.g., GCM 38283; GCM 38905; and GCM 39674) and, under the proposal, it would continue to be the case that not all revenue sharing arrangements would be improper private inurement. However, legislative history would indicate that no inference is intended that Treasury or the Internal Revenue Service are bound by any particular prior unpublished rulings in this area.

[22] The fact that a State or local legislative or agency body may have authorized or approved of a particular compensation package paid to a disqualified person would not be determinative of the reasonableness of compensation paid for purposes of the excise tax penalties provided for by the proposal. Similarly, such authorization or approval would not be determinative of whether a revenue sharing arrangement violates the private inurement proscription.

and IRS would be instructed to issue guidance in connection with the reasonableness standard that incorporates this presumption.

The proposal would specifically provide that the payment of personal expenses and benefits to or for the benefit of disqualified persons, and non-fair-market-value transactions benefiting such persons, would be treated as compensation only if it is clear that the organization intended and made the payments as compensation for services. In determining whether such payments or transactions are, in fact, compensation, the relevant factors would include whether the appropriate decision-making body approved the transfer as compensation in accordance with established procedures and whether the organization and the recipient reported the transfer (except in the case of non-taxable fringe benefits) as compensation on the relevant forms (i.e., the organization's Form 990, the Form W-2 or Form 1099 provided by the organization to the recipient, the recipient's Form 1040, and other required returns).[23]

Consistent with the rule that payment of personal expenses and benefits to or for the benefit of disqualified persons and nonfair-market value transactions benefiting such persons are treated as compensation only if it is clear that the organization intended and made the payments as compensation for services, any reimbursements by the organization of excise tax liability would be treated as an excess benefit unless they are included in the disqualified person's compensation during the year the reimbursement is made. The total compensation package, including the amount of any reimbursement, would be subject to the reasonableness requirement. Similarly, the payment by an applicable tax-exempt organization of premiums for an insurance policy providing liability insurance to a disqualified person for excess benefit taxes would be an excess benefit transaction unless such premiums are treated as part of the compensation paid to such disqualified person.[24]

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[23] With the exception of nontaxable fringe benefits described in present-law section 132 and other types of nontaxable transfers such as employer-provided health benefits and contributions to qualified pension plans, an organization could not demonstrate at the time of an IRS audit that it clearly indicated its intent to treat economic benefits provided to a disqualified person as compensation for services merely by claiming that such benefits may be viewed as part of the disqualified person's total compensation package. Rather, the organization would be required to provide substantiation that is contemporaneous with the transfer of economic benefits at issue.

[24] In addition, because individuals may be both members of, and disqualified persons with respect to, a non-exclusive applicable tax-exempt organization (e.g., a museum or neighborhood civic organization) and receive certain benefits (e.g., free admission, discounted gift shop purchases) in their capacity as members (rather than in their capacity as disqualified persons), legislative history would express the expectation that the Treasury Department would provide guidance clarifying that such membership benefits may be excluded from consideration under the private inurement proscription and intermediate sanction rules.

"Disqualified person" would mean any individual who is in a position to exercise substantial influence over the affairs of the organization, whether by virtue of being an organization manager or otherwise.[25] In addition, "disqualified persons" include certain family members and 35-percent owned entities[26] of a disqualified person, as well as any person who was a disqualified person at any time during the five-year period prior to the transaction at issue. A person having the title of "officer, director, or trustee" would not automatically have the status of a disqualified person.[27] In addition, the Secretary of Treasury would have authority to promulgate rules exempting broad categories of individuals from the category of "disqualified persons" (e.g., full-time bona fide employees who receive economic benefits of less than a threshold amount or persons who have taken a vow of poverty).

A disqualified person who benefits from an excess benefit transaction would be subject to a first-tier penalty tax equal to 25 percent of the amount of the excess benefit (i.e., the amount by which a transaction differs from fair market value, the amount of compensation exceeding reasonable compensation, or (under Treasury regulations) the amount of a prohibited transaction based on the organization's gross or net income). Organization managers who participate in an excess benefit transaction knowing that it is an improper transaction would be subject to a first-tier penalty tax of 10 percent of the amount of the excess benefit (subject to a maximum penalty of $10,000).[28]

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[25] Under the proposal, a person could be in a position to exercise substantial influence over a tax-exempt organization despite the fact that such person is not an employee of (and receives no compensation directly from) a tax-exempt organization, but is formally an employee of (and is directly compensated by) a subsidiary -- even a taxable subsidiary -- controlled by the parent tax-exempt organization.

[26] Family members would be determined under present-law section 4946(d), except that such members also would include siblings (whether by whole or half blood) of the individual, and spouses of such siblings. "35-percent owned entities" would mean corporations, partnerships, and trusts or estates in which a disqualified person owns more than 35 percent of the combined voting power, profits interest, or beneficial interest.

[27] The IRS has issued a general counsel memorandum indicating that all physicians are considered "insiders" for purposes of applying the private inurement proscription. Legislative history would express the intent that physicians will be disqualified persons only if they are in a position to exercise substantial influence over the affairs of an organization.

[28] In determining who is an organization manager, it is intended that principles similar to those set forth in regulations issued under sections 4946 and 4955 with respect to final authority or responsibility for an expenditure be applied. (See Treas. Reg. secs. 53.4946-1(f)(1)(ii), 53.4946-1(f)(2), 53.4955-1(b)(2)(ii)(B), and 53.4955-1(b)(2)(iii)).

Additional, second-tier taxes could be imposed on a disqualified person if there is no correction of the excess benefit transaction within a specified time period.[29] In such cases, the disqualified person would be subject to a penalty tax equal to 200 percent of the amount of excess benefit. For this purpose, the term "correction" would mean undoing the excess benefit to the extent possible and, where fully undoing the excess benefit is not possible, taking such additional corrective action as is prescribed by Treasury regulations.

The intermediate sanctions for "excess benefit transactions" could be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status.[30] If more than one disqualified person or manager is liable for a penalty excise tax, then all such persons would be jointly and severally liable for such tax. As under current law, a three-year statute of limitations would apply, except in the case of fraud (sec. 6501). Under the proposal, the IRS would have authority to abate the excise tax penalty (under present-law section 4962) if it is established that the violation was due to reasonable cause and not due to willful neglect and the transaction at issue was corrected within the specified period.

To prevent avoidance of the penalty excise taxes in cases of private inurement of assets of a previously tax-exempt organization, the proposal would provide that an organization will be treated as an applicable tax-exempt organization subject to the excise taxes on excess benefit transactions if, at any time during the 10-year period preceding the transaction, it was a tax-exempt organization described in section 501(c)(3) or 501(c)(4), or a successor to such an organization.

Effective date.--The provision generally would apply to excess benefit transactions occurring on or after September 14, 1995. The provision does not apply, however, to any benefits arising out of a transaction pursuant to a written contract which was binding on September 13, 1995, and at all times thereafter before such benefits arose, and the terms of which have not materially changed.

In addition, legislative history would indicate that parties to transactions entered into after September 13, 1995, and before January 1, 1997, would be entitled to rely on the rebuttable presumption of reasonableness if, within a reasonable period (e.g., 90 days) after entering into

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[29] Correction would be required to be made on or prior to the earlier of (1) the date of mailing of a notice of deficiency under section 6212 with respect to the first-tier penalty excise tax imposed on the disqualified person, or (2) the date on which such tax is assessed.

[30] In general, the intermediate sanctions would be the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.

the compensation package, the parties satisfy the three criteria that give rise to the presumption. After December 31, 1996, the rebuttable presumption should arise only if the three criteria are satisfied prior to payment of the compensation (or, to the extent provided by the Secretary of the Treasury, within a reasonable period thereafter).

Additional filing and public disclosure rules

Reporting of identity of certain disqualified persons, excise tax penalties and excess benefit transactions.-- Tax-exempt organizations would be required to disclose on their Form 990 the name of each individual who was in a position to exercise substantial influence over the affairs of the organization (but not their family members and 35-percent owned entities) or such other information with respect to disqualified persons as the Secretary of the Treasury may prescribe. In addition, exempt organizations would be required to disclose on their Form 990 such information as the Secretary of the Treasury may require with respect to "excess benefit transactions" (described above) and any other excise tax penalties paid during the year under present-law sections 4911 (excess lobbying expenditures), 4912 (disqualifying lobbying expenditures), or 4955 (political expenditures), including the amount of the excise tax penalties paid with respect to such transactions, the nature of the activity, and the parties involved.[31]

Penalties for failure to file timely or complete return.--The section 6652(c)(1)(A) penalty imposed on a tax-exempt organization that either fails to file a Form 990 in a timely manner or fails to include all required information on a Form 990 would be increased from the present-law level of $10 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of $5,000 or five percent of the organization's gross receipts) to $20 for each day the failure continues (with a maximum penalty with respect to any one return of the lesser of $10,000 or five percent of the organization's gross receipts). Under the proposal, organizations with annual gross receipts exceeding $1 million would be subject to a penalty under section 6652(c)(1)(A) of $100 for each day the failure continues (with a maximum penalty with respect to any one return of $50,000). As under present law, no penalty may be imposed under section 6652(c)(1)(A) if it were shown that the failure to file a complete return was due to reasonable cause (sec. 6652(c)(3)).

Effective date.--The filing and disclosure provisions governing tax-exempt organizations generally would take effect on January 1, 1996 (or, if later, 90 days after enactment). However, the provisions regarding the reporting on annual returns of excise tax penalties and excess

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[31] The penalties applicable to failure to file a timely, complete, and accurate return would apply for failure to comply with these requirements. In addition, it would be intended that the IRS implement its plan to require additional Form 990 reporting regarding (1) changes to the governing board or the certified accounting firm, (2) such information as the Treasury Secretary may require relating to professional fundraising fees paid by the organization, and (3) aggregate payments (by related entities) in excess of $100,000 to the highest-paid employees.

benefit transactions would be effective for returns with respect to taxable years beginning on or after January 1, 1995.

Legislative Background

An identical proposal was contained in the President's seven-year balanced budget proposal released on December 7, 1995. The proposal is substantially identical to the intermediate sanction provisions contained in the BBA of 1995 (sec. 11271) and described in the Conference Report accompanying thereto, except that the proposal would provide that an organization will be treated as an applicable tax-exempt organization subject to the excise taxes on excess benefit transactions if, at any time during the ten-year period preceding the transaction, it was a tax-exempt organization described in section 501(c)(3) or 501(c)(4), or a successor to such an organization. The BBA of 1995 contains a similar provision, but provides for a two-year, rather than a ten-year, period.

H. Extension of Certain Taxes

1. Reinstate Superfund excise taxes and corporate environmental income tax

Present Law

Four different Superfund taxes were imposed before January 1, 1996. These were:

(1) An excise tax on petroleum, imposed at a rate of 9.7 cents per barrel, on domestic or imported crude oil or refined products;

(2) An excise tax on listed hazardous chemicals, imposed at a rate that varied from $0.22 to $4.87 per ton;

(3) An excise tax on imported substances that use as materials in their manufacture or production one or more of the hazardous chemicals subject to the excise tax described in (2) above; and

(4) A corporate environmental income tax equal to 0.12 percent of the amount of modified alternative minimum taxable income of a corporation that exceeded $1 million.

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

Amounts equivalent to the revenues from these taxes were dedicated to the Hazardous Substance Superfund Trust Fund (the "Superfund"). Amounts in the Superfund are available for expenditures incurred in connection with releases or threats of releases of hazardous substances into the environment under specified provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (as amended). Spending from the Superfund is classified as discretionary domestic spending for Federal budget purposes.

Description of Proposal

The three Superfund excise taxes would be extended through September 30, 2002. The corporate environmental income tax would be extended through taxable years beginning before January 1, 2003.

Revenues from the three Superfund excise taxes would be deposited in the Superfund Trust Fund through July 31, 1996; revenues from the corporate environmental income tax would be deposited in the Superfund throughout the period when that tax would be extended.

Effective Date

The reinstatement of the Superfund excise taxes would be effective on the date of the proposal's enactment. The reinstatement of the corporate environmental income tax would be effective for taxable years beginning after December 31, 1995.

Legislative Background

Similar proposals are included in the BBA of 1995 and in the President's seven-year balanced budget proposal released on December 7, 1995..

2. Reinstate Oil Spill Liability Trust Fund excise tax

Present Law

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

Description of Proposal

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

Effective Date

The proposal would be effective after December 31, 1995.

Legislative Background

This proposal is included in the BBA of 1995.

3. Extension of Federal unemployment tax

Present Law

The Federal Unemployment Tax Act (FUTA) imposes a 6.2 percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the minimum, net Federal

unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States are supposed to use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax has been subsequently extended through 1998.

Description of Proposal

The proposal would extend the temporary surtax rate through December 31, 2002.

Effective Date

The proposal would be effective for labor performed on or after January 1, 1999.

I. Certain Individual Income Tax Provisions

1. Disallow rollover under section 1034 to extent of previously claimed depreciation for home office or other depreciable use of residence

Present Law

Rollover

Generally, no gain is recognized on the sale or exchange of a principal residence to the extent that the amount of the sales price of the old residence is reinvested in a new residence within a specified period ("the rollover"). The specified period generally is a period beginning two years before the sale of the old residence and ending two years after the sale of the old residence.

One-time exclusion

In general, a taxpayer may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has used the residence as a principal residence for three or more years of the five years preceding the sale. This election is allowed only once in a lifetime unless all previous elections are revoked. For these purposes, sales on or before July 26, 1978, are not counted against the once-in-a-lifetime limit.

In the case of a mixed use of a residence, the exclusion is limited only to that portion of the residence that is owned and used by the individual as his principal residence for at least three of the previous five years before the date of sale. Gain on the portion not qualifying as a principal residence is not eligible for this exclusion.

Description of Proposal

Rollover

The proposal would provide that gain is recognized on the sale of a principal residence to the extent of any depreciation allowable with respect to such principal residence for periods after December 31, 1995.

One-time exclusion

The proposal would impose an additional restriction on the availability of the one-time exclusion. Specifically, the proposal would provide that the amount of the otherwise allowable one-time exclusion is reduced and therefore the amount of recognized gain is increased to the extent of depreciation allowable with respect to such principal residence for periods after

December 31, 1995. The proposal would not change the amount of the allowable depreciation or the gain recognition treatment on the rental portion of the building under present law.

Effective Date

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

Legislative Background

An identical provision is included in the BBA of 1995.

2. Extension of withholding to certain gambling winnings

Present Law

In general, proceeds from a wagering transaction are subject to withholding at a rate of 28 percent if the proceeds exceed $5,000 and are at least 300 times as large as the amount wagered. The proceeds from a wagering transaction are determined by subtracting the amount wagered from the amount received. Any non-monetary proceeds that are received are taken into account at fair market value.

In the case of sweepstakes, wagering pools, or lotteries, proceeds from a wager are subject to withholding at a rate of 28 percent if the proceeds exceed $5,000, regardless of the odds of the wager.

No withholding tax is imposed on winnings from bingo or keno.

Description of Proposal

The proposal would impose withholding on proceeds from bingo or keno wagering transactions at a rate of 28 percent if such proceeds exceed $5,000, regardless of the odds of the wager.

Effective Date

The proposal would be effective on January 1, 1996.

Legislative Background

H.R. 3419 (103rd Cong.), as passed by the House of Representatives, contained a provision (in section 904 of the bill) to impose withholding on proceeds from bingo or keno wagering transactions at a rate of 28 percent if such proceeds exceed $10,000, regardless of the odds of the wager, effective for payments made after December 31, 1993.

The BBA of 1995 contains an identical provision.

3. Require taxpayers to include rental value of residence in income without regard to period of rental

Present Law

Gross income for purposes of the Internal Revenue Code generally includes all income from whatever source derived, including rents. The Code (sec. 280A(g)) provides a de minimis exception to this rule where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year. In this case, the income from such rental is not included in gross income and no deductions arising from such rental use are allowed as a deduction.

Description of Proposal

The proposal would repeal the 15-day rules of section 280A(g). The proposal would also provide that no reduction in basis is required if the taxpayer: (1) rented the dwelling unit for less than 15 days during the taxable year and (2) did not claim depreciation on the dwelling unit for the period of rental.

Effective Date

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

Legislative Background

An identical provision was included in the BBA of 1995 as passed by the House of Representatives, but was not included in the final conference agreement in the BBA of 1995. Also, a substantially similar provision was included in H.R. 3419 (103rd Congress) as passed by the House of Representatives.

J. Earned Income Credit Provisions

1. Deny credit to individuals not authorized to be employed in the United States

Present Law

In general

Certain eligible low-income workers are entitled to claim a refundable credit on their income tax return. The amount of the credit an eligible individual may claim depends upon whether the individual has one, more than one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

The parameters for the credit depend upon the number of qualifying children the individual claims. For 1996, the parameters are given in the following table (dollar amounts are projections expressed in 1996 dollars):

	Two or more qualifying children--	One qualifying child--	No qualifying children--
Credit rate	40.00%	34.00%	7.65%
Earned income amount	$8,890	$6,330	$4,220
Maximum credit	$3,556	$2,152	$323
Phaseout begins	$11,610	$11,610	$5,280
Phaseout rate	21.06%	15.98%	7.65%
Phaseout ends	$28,495	$25,078	$9,500

For years after 1996, the credit rates and the phaseout rates will be the same as in the preceding table. The earned income amount and the beginning of the phaseout range are indexed for inflation; because the end of the phaseout range depends on those amounts as well as the phaseout rate and the credit rate, the end of the phaseout range will also increase if there is inflation.

In order to claim the credit, an individual must either have a qualifying child or meet other requirements. A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. In order to claim the credit without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

To satisfy the identification test, individuals must include on their tax return the name and age of each qualifying child. For returns filed with respect to tax year 1996, individuals must provide a taxpayer identification number (TIN) for all qualifying children born on or before November 30, 1996. For returns filed with respect to tax year 1997 and all subsequent years, individuals must provide TINs for all qualifying children, regardless of their age. An individual's TIN is generally that individual's social security number.

Mathematical or clerical errors

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

Description of Proposal

Individuals would not be eligible for the credit if they do not include their taxpayer identification number (and, if married, their spouse's taxpayer identification number) on their tax return. Solely for these purposes and for purposes of the present-law identification test for a qualifying child, a taxpayer identification number would be defined as a social security number issued to an individual by the Social Security Administration other than a number issued under section 205(c)(2)(B)(i)(II) (or that portion of sec. 205(c)(2)(B)(i)(III) relating to it) of the Social Security Act (regarding the issuance of a number to an individual applying for or receiving Federally funded benefits).

If an individual fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error. If an individual who claims the credit with respect to net earnings from self-employment fails to pay the proper amount of self-employment

tax on such net earnings, the failure would be treated as a mathematical or clerical error for purposes of the amount of credit allowed.

Effective Date

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

Legislative Background

An identical provision was included in the President's seven-year balanced budget proposal released on December 7, 1995.

A similar provision was included in the President's fiscal year 1996 budget proposal (included in the "Tax Compliance Act of 1995," introduced on February 16, 1995, as H.R. 981 by Representatives Gephardt and Gibbons and as S. 453 by Senators Moynihan and Daschle).

The BBA of 1995 contains an identical provision within a set of broader changes to the earned income credit.

2. Change definition of disqualified income

Present Law

For taxable years beginning after December 31, 1995, an individual is not eligible for the earned income credit if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds $2,350. Disqualified income is the sum of:

(1) interest (taxable and tax-exempt),
(2) dividends, and
(3) net rent and royalty income (if greater than zero).

Description of Proposal

For purposes of the disqualified income test, net capital gain income would be added to the definition of disqualified income.

Effective Date

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

Legislative Background

A similar provision was included in the Senate amendment to H.R. 2491, but it was dropped in conference and therefore not included in the BBA of 1995.

3. Provide advance payment of the credit through State demonstration programs

Present Law

A worker with a qualifying child may elect to receive the earned income credit on an advance basis by furnishing an advance payment certificate to his or her employer. For such a worker, the employer makes an advance payment of the credit at the time wages are paid. The amount of advance payment allowable in a taxable year is limited to 60 percent of the maximum credit available to an individual with one qualifying child. The Internal Revenue Service (IRS) is required to provide notice to taxpayers with qualifying children who receive a refund on account of the credit that the credit may be available on an advance payment basis.

Advance payments by an employer during any payroll period are not treated as a payment of compensation. Instead, they are treated as made out of amounts required to be withheld by the employer for wage withholding of income taxes, FICA employment taxes, and FICA employer taxes as if the employer had paid to the Treasury an amount equal to such advance payments on the day the wages were paid to the employees. If for any payroll period the aggregate amount of advance credit payments made by an employer exceeds the sum described in the previous sentence, each advance payment is reduced by a percentage that equals the ratio of the excess to the aggregate amount of advance credit payments by the employer.

Description of Proposal

In general

A worker participating in a demonstration program would be able to receive the credit on an advance basis from a designated State agency instead of receiving it on an advance basis from his employer.

The amount of advance payment allowable in a taxable year would be limited to 75 percent of the maximum credit available to a taxpayer with the corresponding number of qualifying children. The advance payments could be made on the basis of the participant's payroll period, or a single Statewide schedule, or on any other reasonable basis prescribed by the State, but no less frequently than every calendar quarter.

Advance payments during any calendar quarter would not be treated as a payment of compensation and would not be included in gross income of the recipient. Instead, they would be treated as made out of amounts required to be withheld by the State for wage withholding of income taxes, FICA employment taxes, and FICA employer taxes as if the State had paid to the Treasury an amount equal to such advance payments on the day the advance payments were made to participants. If for any calendar quarter the aggregate amount of advance credit payments made by a State agency would exceed the sum described in the previous sentence, each advance payment would be reduced by a percentage that equals the ratio of the excess to the aggregate amount of advance credit payments by the State agency.

If a participant would receive advance payment amounts in excess of the amount of credit to which the participant is entitled for that year ("excessive advance earned income payments"), the State would be treated as having deducted and withheld as income tax withholding the repayment amount during the repayment calendar quarter. The repayment amount would be 50 percent of the excess of excessive advance earned income payments made by a State in a calendar year over the sum of (1) four percent of all advance payments made by the State during the calendar year, plus (2) the excessive advance earned income payments made by the State during the calendar year that had been collected from participants by the Treasury. The repayment calendar quarter would be the second calendar quarter of the third calendar year after the calendar year in which an excessive advance earned income payment is made.

Demonstration programs

The Secretary of the Treasury, in consultation with the Secretary of Health and Human Services, would select no more than four States for advance payment demonstration programs. The States selected could have in the aggregate no more than five percent of the total number of households participating in the food stamp program during the immediately preceding fiscal year.

In order to be eligible for selection as a demonstration program, a State would have to submit a proposal to the Treasury on or before June 30, 1996. That proposal would have to identify the State agency responsible for making the advanced payments; describe how the agency would make the advanced payments, including how they would be coordinated with other benefits; describe how the State would get information on the amount of advance payments made to each participant; describe the process to select and notify participants for the demonstration program; and describe how the State would verify participants' eligibility for the credit. The proposal would commit the State to providing to the IRS and the participant by each January 31 information returns showing the participant's name, taxpayer identification number (TIN), and amount of advance payments of credit for the preceding calendar year. The proposal would commit the State to providing a written statement to the IRS each December 1 showing the name and TIN of each participant.

The Secretary of the Treasury could revoke a demonstration program's status for failure to comply substantially with the proposal or to comply with the reporting requirements.

Authorization of appropriation

For purposes of providing technical assistance, writing reports, and providing grants to States in support of demonstration programs, there would be authorized to be appropriated in advance to the Secretary of the Treasury and the Secretary of Health and Human Services a total of $1,400,000 for fiscal years 1997 through 2000.

Effective Date

The selection of demonstration programs would be made no later than December 31, 1996. The demonstration programs would be effective for credit advance payments made after December 31, 1996, and before January 1, 2000.

Legislative Background

An identical proposal (except for the effective date and the years covered by the demonstration project) was included in section 741 of the President's 1994 welfare proposal (the "Work and Responsibility Act of 1994," introduced on June 21, 1994, by Representative Gibbons and others as H.R. 4605 (103rd Congress).

K. Other Revenue Provisions

1. Certain Federal assistance includible in income

Present Law

Generally, supplemental security income benefits under title XVI of the Social Security Act are not taxable.

Description of Proposal

Under the proposal supplemental security income benefits under title XVI of the Social Security Act (including supplemental security income benefits of the type described in section 1616 of the Social Security Act or section 212 of Public Law 93-66) would be included in gross income. Supplemental security income, however, would not be taken into account as adjusted gross income for purposes of the earned income credit. The proposal would also provide rules for information reporting and other rules.

Effective Date

The proposal generally would be effective for benefits received after December 31, 1995, except that the provision relating to the earned income credit would be effective for taxable years beginning after December 31, 1995.

2. Dependent care credit to be refundable; phaseout of credit

Present Law

A nonrefundable income tax credit is available for up to 30 percent of a limited dollar amount of employment-related child and dependent care expenses for a dependent who is under the age of 13, or a physically or mentally incapacitated dependent or spouse (sec. 21).

Eligible employment-related expenses are limited to $2,400 ($4,800 if there are two or more qualifying individuals). The 30-percent credit rate is reduced by one percentage point for each $2,000 (or fraction thereof) of AGI above $10,000, but not below 20 percent for AGI above $28,000.

Description of Proposal

The proposal would make two changes to the credit. First, it would make the credit refundable. Second, it would phase out the credit for all taxpayers between $60,000 and $80,000 of AGI.

Effective Date

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

3. Federal income tax refund offset

Present Law

Federal tax refunds must be offset against three types of debt (Code sec. 6402). First, they must be offset against any liability for any internal revenue tax. Second, they must be offset against past-due child support payments. In the case of families receiving specified public assistance payments (primarily AFDC payments), these past-due support payments are assigned to the State that makes the public assistance payments. Third, Federal tax refunds must be offset for the amount of any past-due, legally enforceable debt to a Federal agency.

If a refund is subject to offset both under the Federal agency provision and because of past-due child support, the offset for past-due child support that has been assigned to a State is to be implemented first, the offset for past-due debts owed to Federal agencies second, and the offset for past-due child support not assigned to a State (but owed to the family) last. No court of the United States has jurisdiction to hear any action brought to restrain or review a refund offset made because of either past-due child support or a nontax Federal debt.

Description of Proposal

The proposal would provide that all past-due child support payments (whether or not assigned to a State) are to be offset against a tax refund before any past-due debts owed to Federal agencies are offset.[32]

Effective Date

The proposal would be effective beginning October 1, 1999.

4. IRS collection of child and spousal support arrears

Present Law

If the Secretary of HHS properly certifies to the Secretary of the Treasury with respect to any individual that the individual owes child or spousal support and that payments of those amounts are in arrears, the IRS shall in general collect those arrears in the same manner and with the same powers as if it were a tax (Code sec. 6305). The IRS charges a fee to do this.

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[32] An amendment to Code sec. 6402(d)(2) may be necessary to implement this proposal.

Description of Proposal

The proposal would prohibit the IRS from assessing any additional fee for adjustments with respect to an amount previously certified by the Secretary of HHS with respect to the same obligor.

Effective Date

The proposal would be effective beginning October 1, 1997.

5. Apply mathematical or clerical error procedures for dependency exemptions and filing status when correct taxpayer identification numbers are not provided

Present Law

In general

Individuals who claim personal exemptions for dependents must include on their tax return the name and taxpayer identification number (TIN) of each dependent. For returns filed with respect to tax year 1996, individuals must provide a for all dependents born on or before November 30, 1996. For returns filed with respect to tax year 1997 and all subsequent years, individuals must provide TINs for all dependents, regardless of their age. An individual's TIN is generally that individual's social security number.

If the individual fails to provide a correct TIN for a dependent, the Internal Revenue Service may impose a $50 penalty.

Mathematical or clerical errors

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

Description of Proposal

If a taxpayer fails to provide a correct taxpayer identification number for a dependent, the IRS would be authorized to deny the dependency exemption. Such a change would also have indirect consequences for other tax benefits currently conditioned on being able to claim a dependency exemption (e.g., head of household filing status and the dependent care credit). In addition, the failure to provide a correct taxpayer identification number for a dependent would be treated as a mathematical or clerical error and thus any notification that the taxpayer owes additional tax because of that failure would not be treated as a notice of deficiency.

Effective Date

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

6. Notice of availability of earned income and dependent care credits to be included on W-4 form

Present Law

Under a directive to the Treasury in the Omnibus Budget Reconciliation Act of 1990 (OBRA '90), a taxpayer awareness program was established to inform the taxpaying public of the availability of the earned income and dependent care credits.

Description of Proposal

The directive in OBRA '90 required the use of "appropriate means of communication" to carry out the taxpayer awareness program. The proposal would specify that those means include printing a notice of the availability of the credits on the forms used by employees to determine the proper number of withholding exemptions.

Effective Date

The proposal would be effective as if included in OBRA '90.

APPENDIX:
ESTIMATED BUDGET EFFECTS OF THE "MIDDLE CLASS BILL OF RIGHTS TAX RELIEF ACT OF 1996"
(Included in the Balanced Budget Proposal Submitted by the President on January 6, 1996)

Fiscal Years 1996-2002

[Millions of Dollars]

Provision	Effective	1996	1997	1998	1999	2000	2001	2002	1996-00	1996-02
I. MIDDLE CLASS BILL OF RIGHTS TAX PROVISIONS										
A. Middle-Class Tax Relief										
1. Credit for families with young children	1/1/96	-1,451	-7,228	-7,081	-7,763	-11,096	-9,073	---	-34,619	-43,692
2. Deduction for higher education expenses	1/1/96	-1,736	-5,010	-5,996	-6,679	-6,995	-4,532	---	-26,416	-30,948
B. Provisions Relating to Individual Retirement Plans	1/1/96	235	-445	-964	-1,674	-3,443	-3,630	-2,034	-6,290	-11,954
C. Increase the Self-Employed Health Insurance Deduction (35% in 1996 and 1997; 40% in 1998; 45% in 1999; 50% in 2000; and 30% thereafter)	tyba 12/31/95	-29	-91	-137	-267	-422	-358	---	-945	-1,303
SUBTOTAL: MIDDLE CLASS BILL OF RIGHTS TAX PROVISIONS		**-2,981**	**-12,774**	**-14,178**	**-16,383**	**-21,956**	**-17,593**	**-2,034**	**-68,270**	**-87,897**
II. LIMITATIONS ON CORPORATE AND OTHER TAX PROVISIONS										
A. Revision of Tax Rules on Expatriation	2/6/95	21	37	63	97	139	181	216	357	754
B. Corporate Tax Reforms										
1. Gain recognition for certain extraordinary dividends	da 5/3/95	-56	-100	-71	-33	13	69	104	-247	-74
2. Registration of certain confidential corporate tax shelters	aioIRSg	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[2]	[2]
3. Disallow interest deduction for corporate-owned life insurance policy loans	ipoaa 10/13/95	220	579	883	1,369	1,749	1,856	1,895	4,800	8,551
4. Phase out preferential tax deferral for certain large farm corporations required to use accrual accounting	[3]	26	37	38	39	40	41	42	179	261
5. Reformulate Puerto Rico and possessions tax credit (section 936)	tyba 12/31/96	---	56	175	308	455	616	718	994	2,328
6. Further restrict like-kind exchanges involving foreign property	eoa 12/7/95	2	5	8	11	13	15	17	39	71
7. Eliminate interest allocation exception for certain nonfinancial corporations	tyba 12/31/95	41	93	107	123	141	163	187	505	855
8. Repeal section 1374 for large corporations ($5 million fair market value)	12/7/95	21	42	44	47	49	51	54	203	308

Provision	Effective	1996	1997	1998	1999	2000	2001	2002	1996-00	1996-02
9. Modification of loss carryback and carryforward rules; restrict to 1-year carryback	NOLgtyba 12/31/99	---	---	---	---	-165	1,360	1,695	-165	2,890
10. Require recognition of gain for certain transactions	csa 1/12/96	12	88	93	98	103	109	115	394	618
11. Extend pro rata disallowance of tax-exempt interest expense to all corporations	[4]	24	43	49	56	64	70	73	238	381
12. Limit dividends received deduction (DRD):										
a. Reduce DRD to 50%	dpa 1/31/96	241	383	402	422	443	465	488	1,891	2,844
b. Modify holding period for DRD [5]	dpa 1/31/96	6	14	16	17	18	19	20	71	109
13. Treat certain preferred stock as "boot"	12/7/95	80	147	150	154	160	104	33	692	829
14. Deny interest deduction on certain debt instruments	dia 12/7/95	25	76	136	212	262	288	303	711	1,302
15. Interaction of #14. with #12.a.	dia 12/7/95	1	3	5	8	11	12	12	28	52
16. Defer original issue discount deduction on convertible debt	dia 12/7/95	5	17	36	53	64	78	90	175	343
C. Foreign Tax Provisions										
1. Modification of rules relating to foreign trusts having one or more United States beneficiaries	2/6/95	93	162	171	180	188	197	206	794	1,197
2. Expand subpart F provisions regarding income from notional principal contracts and stock lending transactions	tyba 12/31/95	11	15	10	10	11	12	12	57	80
3. Treat foreign taxes on oil and gas extraction income as royalties (with treaty override)	[6]	800	2,000	2,200	2,400	2,600	2,800	3,000	10,000	15,800
4. Repeal exclusion for foreign earned income (section 911)	tyba 12/31/95	300	1,300	1,400	1,500	1,600	1,700	1,800	6,100	9,600
D. Accounting Provisions										
1. Require thrifts to account for bad debts in the same manner as banks	tyba 12/31/95	63	95	216	280	277	272	260	931	1,462
2. Reform depreciation under the income forecast method	ppisa 9/13/95	18	83	29	13	14	16	19	157	192
3. Repeal lower-of-cost-or-market-method of accounting for inventories	tyba 12/31/98	---	---	---	55	306	330	336	361	1,027
E. Administrative Provisions										
1. Repeal advance refunds of diesel fuel tax for diesel autos, vans, and light trucks	1/1/96	8	19	19	19	19	19	19	84	122
2. Increase penalties for failure to file correct information returns	rda 90 daDOE	12	20	21	22	23	24	25	97	147
F. Casualty and Involuntary Conversion: Modify basis adjustment rules under section 1033	icoa 9/13/95	2	4	7	11	16	23	31	40	94
G. Excise Tax an Amounts of Private Excess Benefits	9/14/95 & 1/1/96	4	4	4	5	5	5	6	22	33
H. Extension of Certain Taxes										
1. Extend Superfund AMT for 7 years	1/1/96	351	612	633	647	672	700	729	2,915	4,345
2. Extend Superfund excise taxes through 9/30/02	DOE	509	695	707	721	736	752	742	3,367	4,860
3. Extend Oil Spill Liability Trust Fund tax through 9/30/02	1/1/96	---	---	---	---	---	63	65	---	128

Provision	Effective	1996	1997	1998	1999	2000	2001	2002	1996-00	1996-02
4. Extend 0.2% FUTA surtax through 2002 (under current law; scheduled to expire 12/31/98) [7]	1/1/99	---	---	---	877	1,199	1,218	1,237	2,076	4,531
I. Certain Individual Income Tax Provisions										
1. Disallow rollover under section 1034 to extent of previously claimed depreciation for home office or other depreciable use of residence	tyea 12/31/95	1	3	4	5	6	8	9	19	35
2. Repeal exemption for withholding on gambling winnings from bingo and keno where proceeds exceed $5,000	1/1/96	20	6	6	6	6	7	7	44	58
3. Repeal 15-day tax-free vacation home rental	tyba 12/31/95	11	22	23	23	24	26	27	103	155
J. Earned Income Credit (EIC) Compliance Provisions										
1. EIC compliance and self-employment taxes	tyba 12/31/95	13	252	261	265	272	276	282	1,062	1,619
2. Modify definition of disqualified investment income test for EIC	tyba 12/31/95	11	111	122	132	143	156	171	519	846
3. Advance payment of earned income tax credit through State demonstration programs	tyba 12/31/96	---	[8]	[8]	[8]	[9]	---	---	[10]	[10]
SUBTOTAL: CORPORATE AND OTHER TAX PROVISIONS		**2,899**	**6,926**	**7,970**	**10,155**	**11,679**	**14,104**	**15,048**	**39,628**	**68,774**
III. OTHER PROVISIONS										
1. Certain Federal assistance includible in income	1/1/96	78	242	276	334	374	429	491	1,304	2,224
2. Modify dependent care credit	1/1/97	---	128	377	433	493	544	622	1,431	2,597
3. Federal income tax refund offset [11]	---	*Presently Unavailable*								
4. IRS collection of arrears [11]	---	*Presently Unavailable*								
5. Apply mathematical or clerical error procedures for dependency exemptions and filing status when correct taxpayer identification numbers are not provided	tyba DOE	---	133	272	262	249	242	234	916	1,392
6. Notice of availability of earned income and dependent care credits to be included on W-4 form	eaii OBRA'90	*Negligible Revenue Effect*								
SUBTOTAL: OTHER PROVISIONS		**78**	**503**	**925**	**1,029**	**1,116**	**1,215**	**1,347**	**3,651**	**6,213**
NET TOTAL		**-4**	**-5,345**	**-5,283**	**-5,199**	**-9,161**	**-2,274**	**14,361**	**-24,991**	**-12,910**

Joint Committee on Taxation, January 24, 1996

NOTE: Details may not add to totals due to rounding.

[Legend and Footnotes for Appendix Table appear on the following page]

Legend and Footnotes for Appendix Table:

Legend for "Effective" column:
aiolRSg = after issuance of Internal Revenue Service guideline
csa = constructive sales after
da = distributions after
dia = debt issued after
DOE = date of enactment
eaii OBRA'90 = effective as if included in the Omnibus Budget Reconciliation Act of 1990
dpa = dividends paid after
eoa = exchanges on or after
icoa = involuntary conversions occurring after
ipoaa = interest paid or accrued after
NOLgtyba = NOLs generated in taxable years beginning after
ppisa = property placed in service after
rda 90 daDOE = returns due after 90 days after date of enactment
tyba = taxable years beginning after
tyea = taxable years ending after

[1] Gain of less than $5 million.
[2] Gain of less than $25 million.
[3] No new suspense accounts could be established in taxable years ending after 9/13/95. The income in existing suspense accounts would be recognized in equal installments over a 20-years period beginning with the first taxable year beginning after 9/13/95.
[4] Effective for taxable years beginning after 12/31/95 with respect to obligations acquired after 12/7/95.
[5] Includes interaction with 50% DRD provision.
[6] Taxes paid, deemed paid, or accrued after 12/31/95.
[7] Estimate provided by the Congressional Budget Office.
[8] Loss of less than $500,000.
[9] Gain of less than $500,000.
[10] Negligible revenue effect.
[11] Estimate to be provided by the Congressional Budget Office.