[JOINT COMMITTEE ON TAXATION]

DESCRIPTION OF MISCELLANEOUS TAX PROPOSALS

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON JUNE 17, 22, AND 24, 1993

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled public hearings on various miscellaneous tax proposals on June 17, 22, and 24, 1993. Additional hearings on certain proposals will be scheduled for a later time.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the proposals, based on proposals submitted to Chairman Rostenkowski by Members of the Committee on Ways and Means.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Miscellaneous Tax Proposals* (JCS-8-93), June 16, 1993.

DESCRIPTION OF PROPOSALS

A. Tax Accounting Provisions

1. Treatment of contributions in aid of construction (H.R. 846)

Present and Prior Law

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

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

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

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

Description of Proposal

The bill (H.R. 846) would restore the contributions in aid of construction provisions that were repealed by the Tax Reform Act of 1986 for regulated public utilities that provide water or sewage disposal services.

Effective Date

The bill would be effective for amounts received after the date of enactment.

2. Capitalization of certain costs associated with natural disasters

Present and Prior Law

No deduction is allowed for costs incurred for permanent improvements or betterments made to increase the value of any property. Rather, such costs must be capitalized into the basis of the underlying property (sec. 263).

The direct, and an allocable portion of the indirect, costs incurred by a taxpayer in the production of real or tangible personal property must be capitalized into the basis of the property (the "uniform capitalization rules" of sec. 263A). The uniform capitalization rules apply to property produced in the farming business unless (1) the property is an animal or a plant with a preproductive period of 2 years or less or (2) in the case of certain plants, the taxpayer elects to have the rules not apply. If the taxpayer so elects, the taxpayer loses the benefits of accelerated depreciation for property used in its farm business. In addition, the uniform capitalization rules do not apply to any costs of a taxpayer in replanting plants bearing an edible crop for human consumption if plants of the same type of crop were lost or damaged (while in the hands of a taxpayer) by reason of freezing temperatures, disease, drought, pests, or casualty (whether or not replanted on the same parcel of land or any other parcel of land of the same acreage in the United States).

The uniform capitalization rules, including the exception for certain re-planted plants, were added by the Tax Reform Act of 1986 (1986 Act). Prior to its repeal by the 1986 Act, section 278(c) of the Internal Revenue Code of 1954 contained a similar rule that provided that otherwise capitalizable costs attributable to a grove, orchard, or vineyard which was replanted after having been lost or damaged by reason of freezing temperatures, disease, drought, pests, or casualty were deductible when paid or incurred.

Description of Proposal

The proposal would provide that if plants bearing an edible crop for human consumption were lost or damaged (while in the hands of the taxpayer) by reason of freezing temperatures, disease, drought, pests, or casualty, sections 263A and 263 would not apply to any preproductive period costs and 80 percent of any other costs of the taxpayer in replanting plants bearing the same type of crop (whether or not replanted on the same parcel of land or any other parcel of land of the same acreage in the United States). In addition, no loss would be allowed under section 165 with respect to any loss for which the costs of replanting would be deducted under this exception.

Effective Date

The proposal would be effective upon the date of enactment.

3. Treatment of platinum fabricated into items used in a trade or business

Present Law

In general

A taxpayer is allowed deductions for the ordinary and necessary expenses incurred in carrying out its trade or business during the year. The costs of items used in a taxpayer's trade or business generally must be capitalized if the items have useful lives that extend beyond the close of the taxable year. Thus, a taxpayer generally is not allowed to deduct the material cost of supplies that were acquired during the year and are on hand at yearend; such costs are recovered when the supplies are consumed. Costs that are capitalized into property that is of a nature that is subject to exhaustion, wear and tear, and obsolescence generally are recovered through depreciation deductions over the life of the property.

The treatment of a cost as being expensed and deducted when incurred, capitalized and deducted when consumed, or capitalized and recovered through depreciation generally must be made pursuant to a method of accounting that clearly reflects income. A taxpayer may change its method of accounting under section 446 with the consent of the Secretary of the Treasury (or may be required to change its method of accounting by the Secretary). In such instances, a taxpayer generally is required to make an adjustment (a "section 481(a) adjustment") to prevent amounts from being duplicated in, or omitted from, the calculation of the taxpayer's income. Pursuant to Internal Revenue Service (IRS) procedures, the section 481(a) adjustment generally is taken into account over a number of taxable years.

Revenue Ruling 90-65

Certain production processes involve the use of precious metals that may become (1) consumed in the process; (2) physically or chemically fabricated into property used in a taxpayer's trade or business and cannot be economically recovered; or (3) physically or chemically fabricated into property used in a taxpayer's trade or business but can be economically recovered. In Revenue Ruling 90-65, 1990-2 C.B. 41 (1990), the IRS held that if economically recoverable precious metals are physically or chemically fabricated into property used in a taxpayer's trade or business and the cost of those metals represents more than half the cost of the object, the cost of the precious metals are nondepreciable and are accounted for separately from the item into which they are fabricated. The ruling revoked and amplified prior IRS rulings. The ruling further held that any change in the taxpayer's method of accounting to conform with the holding of the ruling is a change in a method of accounting to which sections 446 and 481 apply. Thus, any section 481(a) adjustment resulting from the change in the taxpayer's method of accounting would normally be taken into account over a period not to exceed six years.

Description of Proposal

The proposal would provide that in the case of parts fabricated substantially of platinum and used in a manufacturing process, the changed position of the IRS announced in Revenue Ruling 90-65 would apply only to such parts which are placed in service in taxable years beginning after August 13, 1990.

Effective Date

The proposal would be effective upon enactment.

B. Financial Institution Provisions

1. Tax incentives for minority-owned financial institutions

Present Law

Loss limitations

Limitations are imposed on the use of net operating loss carryovers for certain corporate transactions that involve a change in ownership (sec. 382).

Expensing of stock investments

There is no provision under present law that allows the amount of an investment in stock to be expensed (i.e., deducted for the year in which the investment occurs).

Description of Proposal

Loss limitations

The proposal would eliminate the limitations that are imposed on the use of net operating loss carryovers for acquisitions of corporations from the Resolution Trust Corporation or the Federal Deposit Insurance Corporation by qualified minority financial institutions.

A qualified minority financial institution would be defined as a depository institution (as defined in section 3(c) of the Federal Deposit Insurance Act) (1) more than 50 percent of the ownership or control of which is held by one or more minority individuals, and (2) more than 50 percent of the net profits or losses of which accrues to one or more minority individuals. As under the Financial Institutions, Reform, Recovery, and Enforcement Act of 1989, a minority would be defined as any Black American, Native American, Hispanic American, or Asian American.

Expensing of stock investments

The proposal would permit individuals to deduct investments in common or preferred stock in qualified minority financial institutions. An individual could deduct up to $50,000 per year and $250,000 in a lifetime for all such investments.

Effective Date

The proposal would be effective for acquisitions of corporations and of stock after the date of enactment.

2. Permit common trust funds to transfer assets to regulated investment companies without taxation

Present Law

A common trust fund is a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, guardian, or custodian of certain accounts and in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks (sec. 584(a)).

The common trust fund of a bank is not subject to tax and is not treated as a corporation (sec. 584(b)). Each participant in a common trust fund includes his proportional share of common trust fund income, whether or not the income is distributed or distributable (sec. 584(c)).

No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of an interest. Withdrawals from the fund generally are treated as the sale of an interest by the participant (sec. 584(e)).

A regulated investment company ("RIC") also is treated as a conduit for Federal income tax purposes. Present law is unclear as to the tax consequences when a common trust fund transfers its assets to one or more RICs.

Description of Proposal

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

The basis of any asset that is received by a RIC would be the basis of the asset in the hands of the fund prior to transfer (increased by the amount of gain recognized by reason of the rule regarding the assumption of liabilities). In addition, the basis of any RIC shares that are received by a fund participant would be an allocable portion of the participant's basis in the interests exchanged.

The tax-free transfer would not be available to a common trust fund with assets that are not diversified under the requirements of section 368(a)(2)(F)(ii), except that the diversification test would be modified so that Government securities would not be included as securities of an issuer and would be included in determining total assets for purposes of the 25 and 50 percent tests.

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

Effective Date

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

3. Treat small finance companies as small banks for bad debt deduction purposes

Present Law

In general, a deduction is allowed for business debts that become wholly or partially worthless during the taxable year.

However, a bank other than a large bank is allowed a deduction for a reasonable addition to a reserve for bad debts. A "large bank" is a bank with average adjusted bases of all assets in excess of $500 million for the taxable year (or any preceding taxable year beginning after 1986) or that is a member of a parent-subsidiary controlled group with average adjusted bases of all assets in excess of $500 million. A reasonable addition to a reserve for bad debts is determined pursuant to the "experience method." Under the experience method, the reasonable addition is the amount necessary to increase the balance of the reserve for losses on loans (at the close of the taxable year) to the greater of (1) the amount which bears the same ratio to loans outstanding at the close of the taxable year as (a) the total bad debts sustained during the taxable year and the preceding five years, adjusted to reflect recoveries of bad debts during the period, bears to (b) the sum of the loans outstanding at the close of such six years or (2) the lower of (a) the balance of the reserve at the close of the base year, or (b) if the amount of loans outstanding at the close of the taxable year is lower than the amount of loans outstanding at the close of the base year, the amount that bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve at the close of the base year bears to the amount of loans outstanding at the close of the base year. For taxable years beginning after 1987, the "base year" is the last taxable year beginning before 1988.

The term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions. Such term also may include a domestic savings and loan institution, to the extent the reserve method of section 593 does not apply to the institution.

Description of Proposal

An eligible commercial finance company would be allowed a deduction for a reasonable addition to a reserve for bad debts as determined under the experience method. An "eligible commercial finance company" would be defined as a commercial finance company with average adjusted bases of all assets not greater than $500 million or that is a member of a parent-subsidiary controlled group with average adjusted bases of all assets not greater than $500 million. A "commercial finance company" would be defined as a company whose principal business is providing commercial financing through commercial loans, the purchase of accounts receivable, or leveraged leases.

Effective Date

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

4. Treatment of consolidation of certain mutual savings bank life insurance departments

Present Law

Special rules for mutual savings banks with life insurance business.—Present law provides for special treatment of a mutual savings bank conducting a life insurance business in a separate life insurance department (Code sec. 594). Under the special rule, the insurance and noninsurance businesses of such banks are bifurcated, and the tax imposed is the sum of the partial taxes computed on (a) the taxable income of the mutual savings bank determined without regard to items properly allocable to the life insurance business, and (b) the income of the life insurance department, calculated in accordance with the rules applicable to life insurance companies (subchapter L of the Code). This special treatment applies so long as the mutual savings bank is authorized under State law to engage in the business of issuing life insurance contracts, the life insurance business is conducted in a separate department the accounts of which are maintained separately from the other accounts of the mutual savings bank, and the life insurance department would qualify as a life insurance company under Code section 816 if it were treated as a separate corporation.

Rules for corporate reorganizations.—Present law provides that certain corporate reorganization transactions, including recapitalizations, generally are treated as tax-free transactions (sec. 368(a)(1)(E)). No gain or loss is recognized if stock or securities in a corporation that is a party to a reorganization are (in pursuance of the plan of reorganization) exchanged solely for stock or securities in that corporation or in another corporation that is a party to the reorganization, except that gain (if any) to the recipient is recognized to the extent the principal amount of securities received exceeds the principal amount of the securities surrendered (secs. 354, 356(a)(1)). If such an exchange has the effect of distribution of a dividend, then the portion of the distributee's gain that does not exceed his ratable share of the corporation's earnings and profits is treated as a dividend (sec. 356(a)(2)). If the exchange is not treated as a dividend, the recipient generally may take into account income from the exchange under the installment method (provided the requirements for use of the installment method are otherwise met) (sec. 453).

Rules for life insurance companies.—A life insurance company generally is permitted to deduct the amount of policyholder dividends paid or accrued during the taxable year (sec. 808). In the case of a mutual life insurance company, the amount of the deduction for policyholder dividends is reduced (but not below zero) by the differential earnings amount (sec. 809). The term policyholder dividend includes (1) any amount paid or credited (including as an increase in benefits) if the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management; (2) excess interest; (3) premium adjustments; and (4) experience-rated refunds.

Description of Proposal

The proposal would provide that the consolidation of two or more life insurance departments of mutual savings banks into a single life insurance company by requirement of State law would be treated as a tax-free reorganization described in section 368(a)(1)(E) (i.e., a recapitalization). Any payments required to be made to policyholders in connection with the consolidation would be treated as policyholder dividends deductible by the company under section 808, provided that certain requirements are met. The requirements would be: (1) the payments are only with respect to policies in effect immediately before the consolidation; (2) the payments are only with respect to policies that are participating (i.e., on which policyholder dividends are paid) before and after the consolidation; (3) the payments cease with respect to any policy if the policy lapses after the consolidation; (4) the policyholders before the consolidation had no divisible right to the surplus of any life insurance department and had no right to vote; and (5) the approval of the policyholders was not required for the consolidation.

Effective Date

The proposal would be effective on December 31, 1991.

5. Tax treatment of financial asset securitization investment trusts (H.R. 2065)

Present Law

The ownership of income-producing assets can be structured several different ways, with different consequences for Federal income tax purposes. An individual can own income-producing assets directly, or indirectly through an entity. That entity may be an entity that is subject to tax, or an entity that is a conduit generally not subject to tax or a partial conduit that generally is subject to tax only to the extent its income is not distributed to its owners.

Direct ownership

An individual who owns income-producing assets directly generally includes all income generated by the property, and deducts or capitalizes all items of expense related to the property. When such assets are disposed of in a taxable transaction, the individual recognizes gain or loss, which may be capital gain or loss.

Indirect ownership

An individual can own income-producing assets indirectly through the ownership of an interest in an entity that owns such assets. These entities include corporations, partnerships, and trusts.

Corporations.—A corporation generally is a taxable entity, separate from its stockholders.[2] Thus, income earned by a corporation is taxed to the corporation. In addition, when the after-tax earnings of a corporation are distributed to the corporation's stockholders as

[2] Certain corporations may be treated as complete or partial conduit entities, however. *See* discussion of S corporations, regulated investment companies, real estate investment trusts, and real estate mortgage investment conduits, below.

dividends, generally such earnings also are taxed to the stockholders. Because interest is deductible, as described below, a corporation may reduce its entity-level tax and tend more toward treatment as a conduit entity the more it uses debt in its capital structure.

Partnerships.—A partnership generally is a complete conduit for Federal income tax purposes. Thus, each partner takes into account his "distributive share" of the partnership's income, loss, deduction, and credit separately. A partnership itself generally has no Federal income tax liability.

Trusts.—A trust generally is treated as a partial conduit for Federal income tax purposes since the trust, although in form a separate taxable entity, is allowed a deduction for amounts distributed to its beneficiaries, which amounts generally are includible in the beneficiaries' income.[3] A trust is an arrangement whereby trustees take title to property and become responsible for the protection and conservation of such property on behalf of the persons holding the beneficial interest in the property.

Classification rules.—Treasury regulations provide that whether a particular entity is classified as an association taxable as a corporation or as a partnership, trust, or some other entity not taxable as a corporation is determined by taking into account the presence or absence of certain characteristics associated with corporations. These characteristics are (1) the presence of associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for entity debts limited to entity property, and (6) free transferability of interests in the entity.[4]

Corporations and partnerships share the first two characteristics described above, and so the classification of an unincorporated entity as an association taxable as a corporation rather than a partnership depends on whether the entity has at least three of the remaining four characteristics. Nonetheless, certain entities that otherwise satisfy the test for partnership classification, but whose interests are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof), are treated as corporations for Federal income tax purposes (sec. 7704).

Corporations and trusts share the last four characteristics described above. Accordingly, the Treasury regulations provide that whether a particular unincorporated entity is treated as a trust or as an association taxable as a corporation depends on whether the entity has associates and an objective to carry on business and divide the gains therefrom.[5] Generally, if the purpose of an arrangement is to grant to trustees exclusive responsibility for the protection and conservation of trust property, and the persons with the beneficial interest in the property cannot share in the discharge of

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[3] In the case of a grantor trust, a "grantor" is treated as directly owning the assets held by the trust. A grantor trust is an arrangement under which legal title to property is transferred to a trustee, but the transferor retains certain powers over, or interests in, the trust so that the transferors are treated as retaining direct ownership of such property for Federal income tax purposes (secs. 671-679). Thus, income, deductions, and credits of the grantor trust are attributed directly to the grantors.

[4] Treas. Reg. sec. 301.7701-2(a).

[5] Treas. Reg. sec. 301.7701-2(a)(2).

that responsibility, there are no associates or objective to carry on business. Such an arrangement generally is treated as a trust.[6] A trust that holds income-producing assets (such as a fixed investment trust) may be treated as a trust if there is no power under the trust agreement to vary the investment.[7]

Under Treasury regulations, an arrangement having more than one class of ownership interests generally is not treated as a trust, but is treated as a corporation for Federal income tax purposes.[8] Under these regulations, a trust is treated as having one class of ownership if all of the beneficiaries of the trust have undivided interests in all of the trust property. Thus, under the regulations, if a trust held a portfolio of debt obligations, and interests in the trust assets were divided so that one class of beneficiaries was to receive all principal collected by the trust and a specified rate of interest thereon, until the trust had collected a specified amount of principal on the debt obligations, and another class of beneficiaries was to receive all remaining amounts collected by the trust, such trust would be treated as an association taxable as a corporation.

Statutory vehicles

The Internal Revenue Code (the "Code") establishes a number of vehicles that are treated as conduits or partial conduits through which individuals can own income-producing assets indirectly. These vehicles include S corporations, real estate investment trusts, regulated investment companies and real estate mortgage investment conduits.

S corporations.—An S corporation generally is a complete conduit for Federal income tax purposes. Thus, although S corporations are corporate entities, their shareholders generally account for a proportionate amount of the corporation's items of income, loss, deduction, and credit separately under subchapter S of the Code (secs. 1361 *et seq.*). The S corporation itself generally has no tax liability. In general, to be entitled to elect and retain S corporation status, a domestic corporation must have 35 or fewer shareholders (none of whom are corporations or nonresident aliens) and may issue only one class of stock.

Real estate investment trusts ("REITs").—A REIT generally is treated as a partial conduit for Federal income tax purposes. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed to shareholders on a current basis, provided that the REIT makes certain minimum annual distributions (sec. 857). Income that is not distributed to a REIT's shareholders currently is taxed at the REIT level, as in the case of ordinary corporations.

In general, an entity may qualify as a REIT if it is a trust or corporation with freely transferable interests, the beneficial ownership of which is held by 100 or more persons, which trust or corporation would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements, including that its assets are comprised substantially of real estate assets and its income is substantially realized from certain real estate and related

[6] Treas. Reg. sec. 301.7701-4(a).
[7] Treas. Reg. sec. 301.7701-4(c).
[8] Treas. Reg. sec. 301.7701-4(c)(1).

sources. A REIT's ability to engage in regular business activities is limited by a requirement that income from the sale or other disposition of stock or securities held for less than 1 year, real property held for less than 4 years, or certain other property, must account for less than 30 percent of the REIT's gross income. Further, a 100 percent tax is imposed on gains from the sale of property held for sale to customers in the ordinary course of the REIT's trade or business (other than foreclosure property).

Regulated investment companies ("RICs").—In general, a RIC is an electing domestic corporation that either meets, or is excepted from, certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80), that derives at least 90 percent of its ordinary income from specified passive income and that meets certain other requirements, such as asset diversification requirements. A RIC, like a REIT, generally is subject to the regular corporate tax, but receives a deduction for dividends paid to its shareholders, provided that it meets certain minimum annual income distribution requirements. The ability of a RIC to engage in short-term trading of its assets is limited by a requirement that less than 30 percent of the RIC's gross income may be derived from gain on the sale or other disposition of stock or securities held for less than three months.

Real estate mortgage investment conduits ("REMICs").—In general, a REMIC is an entity that owns a fixed pool of mortgages and that issues multiple classes of interests in that pool. If specified requirements are met, the REMIC generally is not subject to Federal income tax.

The income of the REMIC is allocated to, and taken into account by, the holders of the interests therein. Holders of "regular interests" issued by a REMIC generally take into income the portion of the REMIC's income that would be recognized by an accrual method holder of a debt instrument having the same terms as the particular regular interest; holders of "residual interests" take into account all of the taxable income of the REMIC not taken into account by the holders of the regular interests or the net loss of the REMIC.

A portion of the income a residual holder derives from a REMIC is treated as unrelated business taxable income for tax-exempt entities and as subject to withholding at the statutory rate when paid to foreign persons, and generally may not be offset by net operating losses.

A REMIC's ability to engage in an active business is limited by a 100 percent tax on its net income from certain prohibited transactions, including certain dispositions of the assets a REMIC is entitled to hold, the receipt of income from assets other than assets a REMIC is entitled to hold, and the receipt of any compensation for services.

REMICs are the exclusive means of issuing multiple class real estate mortgage-backed securities without the imposition of two levels of Federal income tax. Any arrangement that qualifies as a "taxable mortgage pool" ("TMP") is treated as a taxable corporation that is not an includible corporation for purposes of filing consolidated returns. Any entity other than a REMIC is a TMP if (1) substantially all of the entity's assets consist of debt obligations (or interests in debt obligations) and a majority of the assets consists of real estate mortgages, (2) the entity issues debt obligations with two or more maturities, and (3) payments on such debt obligations are to bear a relationship to payments on the debt obligations (or interests therein) held by the entity.

Treatment of debt obligations

Deduction for interest paid.—Interest on debt incurred by a corporation to finance the acquisition of income-producing assets generally is deductible to the corporation incurring the debt. To the extent that income from debt-financed property is paid to the debtholders in the form of interest, the interest deduction offsets any corporate-level tax on such income, resulting in the imposition of only a single tax on the income, which is borne by the debtholder. In contrast, a corporation is not able to deduct dividends distributed to shareholders for purposes of calculating its taxable income.

Classification rules.—The determination of whether an instrument issued by a corporation is debt or equity is based on all the facts and circumstances. Factors that may be taken into account to determine whether an interest in a corporation is debt include (1) whether a written unconditional promise exists to pay on demand or on a specified date a sum certain in money and to pay a fixed rate of interest, (2) whether a preference exists over any other indebtedness of the corporation, (3) the ratio of debt to equity of the corporation, (4) whether the interest is convertible into the stock of the corporation, and (5) whether there is a relationship between stock holdings and debt ownership. The Secretary of the Treasury is authorized to prescribe regulations to determine whether an interest in a corporation is stock or debt for Federal tax purposes (sec. 385(a)). Treasury regulations were issued under this authorization, but were subsequently withdrawn.

Original issue discount.—If the borrower receives less in a lending transaction than the amount to be repaid at the loan's maturity, the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money.[9] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount (provided that such discount is not less than a certain *de minimis* amount) to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.

Special rules for calculating the accrual of OID apply to regular interests in REMICs, qualified mortgages held by REMICs, and any debt instruments that have maturities that are initially fixed, but that may be accelerated based on prepayments of other debt obligations securing the debt instruments (or, to the extent provided in Treasury regulations, by reason of other events) (sec. 1272(a)(6)). These rules require OID for an accrual period to be calculated taking into account expected and actual rates of prepay-

[9] *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

ments of the principal of the REMIC regular interests, the REMIC qualified mortgages, or the debt instruments.

Market discount.—Similarly, a debt obligation may be subject to the market discount rules (sec. 1276-1278). Market discount is defined as the excess of the stated redemption price of an obligation over its basis immediately after acquisition (provided that such excess is not less than a certain *de minimis* amount). In the case of a bond that has original issue discount, for purposes of the market discount rules, its stated redemption price generally is treated as the sum of its issue price and the amount of original issue discount that would have been includible in the income of an original holder.

Unlike in the case of OID, a holder of a debt obligation generally is not required to include accrued market discount in income currently. In general, however, gain on the disposition of a debt obligation that was issued after July 18, 1984, generally is treated as ordinary income to the extent of any accrued market discount. In addition, if indebtedness is incurred to purchase or carry a debt obligation that has market discount, interest on such indebtedness in excess of the amount of interest includible in income with respect to such obligation is deductible only to the extent that such interest exceeds the accrued market discount allocable to the taxable year.

Coupon stripping rules.—Where there is a separation of ownership of the right to receive any payment of principal or interest on a debt obligation, other than a pro rata share of all payments, the holder who disposes of the right to receive certain payments on the debt obligation must allocate his basis in the obligation between the portion of the debt obligation that is disposed of and the portion retained for purposes of recognizing gain or loss (sec. 1286). This allocation is made based on the two positions' relative fair market values. The OID rules then govern the amount that the respective holders of the "stripped" debt obligation and the "stripped" coupons must include in income annually.

Description of Proposal

In general

The bill (H.R. 2065) would create a new type of statutory entity called a financial asset securitization investment trust (a "FASIT") that would facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally would not be taxable as a corporation; the FASIT's taxable income or net loss would flow through to the persons holding ownership interests in the FASIT. Ownership interests issued by a FASIT would be required to satisfy certain tests and FASIT ownership interests generally could be held only by corporations and certain other specified entities. In addition, a FASIT generally could hold only debt obligations and would be subject to certain restrictions on its activities. An entity or arrangement that qualified as a FASIT could issue certain instruments with yields to maturity of up to 5 percentage points over the yield to maturity on specified United States government obligations and treat those instruments as debt without concern that such instruments would be recharacterized as equity for Federal income tax purposes.

Qualification as a FASIT

In general.—In order for an entity or arrangement to qualify as a FASIT, it would be subject to certain requirements, including (1) the entity or arrangement must elect to be treated as a FASIT, (2) it must use a calendar taxable year, (3) the ownership interests it issues must meet the criteria described below, (4) its assets must be limited to certain specified assets described below, and (5) it must restrict the types of activities in which it can engage, as described below.

Ownership interests issued by FASITs.—To qualify as a FASIT, an entity or arrangement could issue only two types of ownership interests—common ownership interests and preferred ownership interests.

A common ownership interest would be any ownership interest designated as a common ownership interest. A FASIT could issue only one class of common ownership interests but could issue multiple classes of preferred ownership interests.

A preferred ownership interest in a FASIT would be required to be designated as a preferred ownership interest. In addition, a preferred ownership interest would be required to (1) unconditionally entitle the holder to receive a specified principal amount, (2) have a maturity of no more than 15 years, (3) be issued without a premium over its principal amount, and (4) pay any interest based on one or more rates that, on the date of issuance, are fixed or qualify as permissible variable rates under the rules that apply to regular interests in REMICs under section 860G(a)(1)(B) ("qualified interest").

Permitted holders of ownership interests in FASITS.—The class of persons that could hold FASIT ownership interests would be limited. To qualify as a FASIT, an entity or arrangement would be required to have in place reasonable procedures to ensure that its ownership interests would be held only by RICs, partnerships, trusts, estates, S corporations, or certain cooperatives ("passthrough entities"), or other FASITs, or taxable corporations (collectively, "permitted holders").[10]

Permitted assets of FASITs.—For an entity or arrangement to qualify as a FASIT, substantially all of its assets would be required to consist of (1) debt obligations, (2) cash, (3) foreclosure property acquired on default (or imminent default) of debt obligations held by the FASIT (subject to certain limitations as to the time the FASIT could retain such assets), (4) instruments or contracts that represented a hedge or guarantee of debt held or issued by the FASIT, and (5) interests in other FASITs (collectively, "permitted assets"). A FASIT would have to meet this test at the close of the second calendar quarter after its formation and each calendar quarter thereafter. Permitted assets could be acquired at any time by a FASIT, including any time after its formation.[11]

Permitted activities of FASITs.—In general, a FASIT could only invest in, rather than trade, permitted assets. To be treated as a FASIT, an entity or arrangement must have governing documents

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[10] Certain excise taxes would apply to transfers of FASIT ownership interests to, and FASIT income derived by, holders that are not permitted holders, as described below.

[11] An excise tax would apply to income realized by a FASIT from assets that are not permitted assets, as described below.

that prohibit the acquisition or disposition of assets (1) other than in accordance with the agreements pursuant to which the entity's or arrangement's debt instruments or ownership interests were issued, and (2) for the primary purpose of recognizing increased gain or decreased losses from changes in the market value of the assets. In addition, these governing documents would be required to prohibit the acquisition of debt obligations for the primary purpose of realizing income or gain from property acquired or to be acquired by the FASIT on the default (or imminent default) of such debt obligations.[12]

Debt instruments issued by FASITs

The bill would allow FASITs to issue "qualified debt instruments" that would be treated as debt for Federal tax purposes, regardless of whether instruments with similar terms issued by non-FASITs might be recharacterized as equity. To be treated as a qualified debt instrument an instrument would be required to (1) unconditionally entitle the holder to receive a specified principal amount, (2) have a maturity of no more than 15 years, (3) be issued with a premium of not more than 25 percent of its principal amount, and (4) have a yield to maturity at issue no more than five percentage points above the yield to maturity on outstanding marketable obligations of the United States government having a comparable maturity. Further, any interest payable on the instrument would be required to be of a type that would be qualified interest under the rules that apply to FASIT preferred ownership interests.

The holder of a qualified debt obligation of a FASIT would be treated as holding a debt obligation of a corporation for Federal income tax purposes.

Taxation of the income of FASITs

In general.—Under the bill, the taxable income of a FASIT would be calculated as if it were a corporation. The constant yield method and principles that apply for purposes of determining OID accrual on debt obligations whose principal is subject to acceleration would apply to all debt obligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments. All income, gain, and loss of a FASIT generally would be treated as ordinary. A FASIT's income would be allocated to the holders of its ownership interests, as described below.

A FASIT would be subject to tax on certain of its income. A FASIT would be required to pay a tax equal to 100 percent of its net income from assets other than permitted assets and from transactions in which the FASIT's governing documents prohibit it from engaging. A FASIT also would be subject to tax at the highest corporate rate on any net income from foreclosure property. For this purpose, net income would be computed without taking into account any losses from such assets or transactions.

Further, if a FASIT qualified as a taxable mortgage pool, it would be subject to tax as a corporation on all of its taxable income.

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[12] An excise tax would apply to income realized by a FASIT from prohibited activities, as described below.

Taxation of holders of ownership interests.—A holder of a FASIT ownership interest would take into account its daily portion of the FASIT's taxable income or net loss allocable to ownership interests of the same class.[13] A FASIT's taxable income would be allocated first to owners of the preferred ownership interests, in the order of their preferences, as if the preferred ownership interests were debt obligations having the same terms as the preferred ownership interests. The remaining taxable income of the FASIT would be allocated to the holders of the common ownership interests.

Any net losses of a FASIT would be allocated first to the holders of its common ownership interests to the extent of their bases in the interests (determined as if they were the original holders of such interests). Remaining losses would be allocated to the holders of the preferred ownership interests to the extent of their bases in the interests (determined as if they were the original holders of such interests). Finally, any remaining losses would be allocated to the holders of the common ownership interests. The amount of any net loss a holder of an interest in a FASIT could take into account would be limited to the adjusted basis of the holder's ownership interests in the FASIT. Disallowed losses would be carried forward by the holder.

Certain accrued income of a FASIT would be subject to special rules to ensure that it was not reduced by a holder's net operating losses. Under the bill, the taxable income of a holder of a common ownership interest in a FASIT (treating all members of an affiliated group filing consolidated tax returns as a single holder) generally would not be less than a specified portion of the taxable income of the FASIT (the "front-loaded income"). This rule would not apply in any period in which the debt obligations held by the FASIT had an anticipated weighted average life of less than four years (determined at the end of each calendar quarter), or if under Treasury regulations it could be anticipated that taxable income would not be required to be included by the holder of common ownership interests substantially faster than if the common ownership interests were taxed as debt obligations. Further, the front-loaded income rules would not apply to any common ownership interest held by the originator of the debt obligations transferred in exchange for that ownership interest (or by a member of the same affiliated group that files consolidated Federal income tax returns) and that represents a substantial economic interest in the value or performance of such debt obligations. Front-loaded income would not be taken into account for purposes of determining a taxpayer's net operating loss deduction for a taxable year.

The portion of the income of the holder of a common ownership interest treated as front-loaded income would be the excess, if any, of (1) the amount of the net income of the FASIT that such a holder took into account for the taxable year and for all prior years, over (2) (a) the amount that such holder would have been required to take into account for the taxable year and all prior years if the common ownership interest were treated as a debt obligation origi-

[13] The daily portion of a FASIT's taxable income or net loss is determined by allocating to each day in a calendar quarter the ratable portion of the taxable income for the quarter allocable to the same class of interests and by dividing the amounts so allocated proportionately among the holders (on such day) of ownership interests of that class.

nally issued to the holder on the date of its acquisition for an amount equal to its fair market value on that date, and (b) the amount treated as front-loaded income in all prior taxable years. When the foregoing test would require the determination of a yield to maturity of the hypothetical debt instrument, the bill provides that the yield would be 120 percent of the applicable Federal rate (within the meaning of sec. 1274(d)), unless there was clear evidence that a higher yield was proper.

Transfers to and distributions from FASITs

Treatment of FASITs.—Under the bill, a FASIT would have a fair market value basis in assets contributed to it.

A distribution of assets by a FASIT with respect to an interest or instrument would be treated, except in limited circumstances, as a sale of the assets and distribution of the sale proceeds.

Treatment of transferors.—A transferor of property to a FASIT would recognize gain or loss on the transfer, but that gain or loss could be deferred. If the transferor retained an interest in, or instrument of, the FASIT, the recognized gain or loss would be taken into account over time as the premium or discount on such contributed assets would have been taken into account by the FASIT (i.e., on a constant yield basis). If the transferor sold or disposed of such an interest or instrument in a taxable transaction, the amounts treated as received for such interest or instrument would be allocated among the outstanding assets contributed by the transferor to the FASIT (but not in excess of the outstanding principal amount of the assets after taking into account this rule) and would be treated as payments of principal with respect to those assets, but only for purposes of determining the deferred gain or loss the transferor would be required to recognize.

The bill contains a consistency rule for transfers of property to FASITs. Transferors would be required to treat the FASIT rules as an adoption of a method of accounting. Special rules would require a transferor that retained interests in, or instruments of, a FASIT (or a related party) to treat subsequent transfers of substantially similar debt obligations to certain specified entities as if made to a FASIT.

A transferor of property to a FASIT would have a basis in any interest in, or instrument of, the FASIT received in exchange therefor equal to the fair market value of the interest or instrument immediately after the transfer. A holder's ownership interest in a FASIT would be increased by the amount of any contributions by such person to the FASIT and any taxable income taken into account by such person with respect to such interest, and decreased (but not below zero) by the amount of any distributions to such person by the FASIT and any loss taken into account by such person with respect to such interest.

Treatment of distributees.—A holder who received a distribution with respect to an ownership interest in a FASIT would not include the amount of the distribution in income to the extent of the holder's adjusted basis in the interest. A distribution would be treated as gain on the sale or exchange of an ownership interest to the extent that the distribution exceeded a holder's adjusted basis in the ownership interest.

Excise taxes on non-permitted holders of FASIT ownership interests

The bill would impose an excise tax on any transfer of an ownership interest in a FASIT to a person other than a permitted holder. The excise tax would be equal to the highest corporate income tax rate times the fair market value of the ownership interest. The transferor generally would be liable for this excise tax unless the transfer was made through an agent of the owner, in which case the agent would be liable. The transferor would not be subject to liability for the tax if it obtained from the transferee an affidavit that the transferee was a permitted holder and the transferor had no actual knowledge that the affidavit was false. The bill would provide the Secretary of the Treasury with authority to waive this excise tax if steps were taken so that the FASIT ownership interest was no longer held by a holder other than a permitted holder.

The bill also would provide that if, at any time during a taxable year of a pass-through entity, the pass-through entity held, directly or indirectly, an ownership interest in a FASIT, and a record holder of an interest in the pass-through entity was not itself a permitted holder, the pass-through entity would be subject to a tax at the highest corporate rate on any taxable income from the ownership interest that was allocable to any such record holder. This tax generally would not apply to a pass-through entity that originated the debt obligations held by the relevant FASIT in connection with the pass-through entity's sale of goods or services, or to any pass-through entity that was a dealer in FASIT ownership interests. The tax on pass-through entities would not apply if a pass-through entity obtained from the record holder an affidavit that the record holder was a permitted holder and the pass-through entity had no actual knowledge during the period that the affidavit was false.

Effective Date

The bill would be effective on the date of enactment.

6. Deductibility of bad debt losses of nonbank lending institutions

Present Law

Bad debt deductions of taxpayers that are not banks

Under present law, taxpayers are permitted a deduction for any debt that is acquired or incurred in the taxpayer's trade or business and becomes wholly or partially worthless. In determining whether a debt is worthless in whole or in part, all pertinent evidence, including the value of any collateral and the financial condition of the debtor, are to be taken into account. Treas. Reg. sec. 1.166-2(a).

Bad debt deductions of banks

All banks also are allowed a deduction for bad debts that become wholly or partially worthless (the "specific charge-off method"). In addition, a commercial bank whose average adjusted basis of all assets does not exceed $500 million (i.e., a "small bank") also is allowed a deduction for a reasonable addition to a reserve for bad debts (the "reserve method"). The reasonable addition to the reserve is an amount computed on the basis of a moving six year average of the loans that became worthless in those years (the "experience method").

Treasury regulations contain two special rules under which debts of regulated banks (and certain other corporations) that are charged off for accounting purposes are conclusively presumed to be worthless for Federal income tax purposes. Both apply only if the bank is subject to supervision by a Federal authority or a State authority maintaining substantially equivalent standards. Under the first rule, the presumption generally applies if the charge-off is in obedience to the specific orders of either authority or is in accordance with regulatory policies (provided a letter confirming the charge-off is received in the next audit of the bank). Under the second rule, the presumption generally applies if the bank makes a proper election and receives an express determination letter from its Federal supervisory authority affirming that the bank maintains and applies loan loss classification standards that are consistent with regulatory standards. Treas. Reg. secs. 1.166-2(d) and 1.166-2T(a).

Description of Proposal

Under the proposal, in the case of a nonbank lending institution the stock of which is publicly traded and that has a high volume of low balance, homogeneous loans, a loan of that type would be presumed worthless no later than the time it would be determined worthless under the regulatory criteria applicable to regulated depository institutions, such as banks and thrift institutions, so long as the loan has been charged off for financial accounting purposes.

C. Insurance Provisions

1. Small life insurance companies

a. Treatment of small life insurance companies under the alternative minimum tax

Present Law

Present law provides that certain life insurance companies are allowed a small life insurance company deduction (sec. 806). The amount of the deduction is equal to 60 percent of tentative life insurance company taxable income up to $3,000,000 (determined by treating all life insurance members of a controlled group as one life insurance company). The amount of the deduction is reduced by 15 percent of the tentative life insurance company taxable income in excess of $3,000,000, and thus is reduced to zero for tentative life insurance company taxable income exceeding $15,000,000. Eligible life insurance companies are those with assets not exceeding $500,000,000, determined on a controlled group basis (including both insurance and non-insurance members of the group).

Under present law, all corporations, including insurance companies, are subject to an alternative minimum tax. Alternative minimum taxable income is increased by 75 percent of the excess of adjusted current earnings over alternative minimum taxable income (determined without regard to the adjusted current earnings adjustment and without regard to net operating losses) (sec. 56(g)). In determining adjusted current earnings, no deduction is allowed for any item if the item would not be deductible for any taxable year for purposes of computing earnings and profits (sec. 56(g)(4)(C)(i)). The small life insurance company deduction is not allowed in determining adjusted current earnings.

Description of Proposal

The proposal would allow a life insurance company to determine its adjusted current earnings under the alternative minimum tax by taking into account the amount of the small life insurance company deduction that the company is allowed for regular tax purposes under section 806 of the Code.

Effective Date

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

b. Treatment of policy acquisition expenses of small insurance companies

Present Law

Present law provides that specified policy acquisition expenses of an insurance company are required to be capitalized and amortized ratably generally over a 120-month period (sec. 848). A special rule provides that an insurance company's first $5,000,000 of specified policy acquisition costs may be amortized ratably over 60 months rather than 120 months; the $5,000,000 amount is phased out ratably for insurance companies with specified policy acquisition expenses exceeding $10,000,000 and is reduced to zero when such expenses exceed $15,000,000. In the case of a controlled group (defined to include non-insurance and insurance members, including certain foreign insurance members), all insurance company members are treated as one company.

Specified policy acquisition expenses are determined as a percentage of net premiums for each of three categories of specified insurance contracts. Specified insurance contracts means any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof (excluding pension plan contracts, flight insurance or similar contracts, and certain foreign contracts). For annuity contracts, the percentage is 1.75; for group life insurance contracts, the percentage is 2.05; and for other specified insurance contracts, the percentage is 7.7. Specified policy acquisition expenses may not exceed the company's general deductions for the taxable year.

Description of Proposal

The proposal would provide an exception to the requirement that specified policy acquisition expenses be capitalized and amortized, in the case of certain insurance companies. Eligible insurance companies would be those companies whose (a) assets are less than $25,000,000, determined in accordance with the rules for determining assets under section 806, and (b) specified policy acquisition expenses are less than $4,000,000 for the taxable year, determined on a controlled group basis (including non-insurance and insurance members, and including certain foreign members) and treating all insurance company members of the group as one company.

Effective Date

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

c. Capitalization of policy acquisition expenses for small life insurance companies

Present law

Under Code section 848, insurance companies must capitalize specified policy acquisition expenses (i.e., a statutorily determined amount of otherwise deductible expenses) for any taxable year and amortize such expenses ratably, generally over a period of 120 months.[14] The amount of specified policy acquisition expenses in any taxable year is determined generally by multiplying the net premiums relating to certain specified insurance contracts by a statutorily prescribed percentage (which differs depending upon the type of contract). The amount of specified policy acquisition costs for any taxable year, however, may not exceed the company's general deductions for that year.

Specified insurance contracts covered by section 848 are life insurance contracts, annuity contracts, noncancellable or guaranteed

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[14] A more favorable 60-month amortization period is allowed for the first $5 million of specified policy acquisition expenses during any taxable year. This benefit is phased out on a dollar-for-dollar basis if specified policy acquisition expenses exceed $10 million.

renewable accident and health insurance contracts, and any contract which is a combination of any of the foregoing contracts.[15] (Specified insurance contracts, however, do not include any pension plan contract, flight insurance contract, or qualified foreign contract.) The statutorily prescribed percentages for determining specified policy acquisition expenses are as follows: (1) annuity contracts, 1.75 percent; (2) group life insurance, 2.05 percent; and (3) other specified insurance contracts, 7.7 percent.

Description of Proposal

The percentage of net premiums to be used by a small life insurance company in computing specified policy acquisition expenses with respect to specified insurance contracts (other than group life insurance and annuity contracts) would be reduced from 7.7 percent to 3.85 percent. For this purpose, a small life insurance company means any insurance company which meets the requirements of section 806(a)(3), i.e., generally one with less than $500 million of assets at the close of the taxable year.

Effective Date

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

2. Treatment of certain personal injury liability assignments (H.R. 1416)

Present Law

Under present law, an exclusion from gross income is provided for amounts received for agreeing to a qualified assignment to the extent that the amount received does not exceed the aggregate cost of any qualified funding asset (sec. 130). A qualified assignment means any assignment of a liability to make periodic payments as damages (whether by suit or agreement) on account of a personal injury or sickness (in a case involving physical injury or physical sickness), provided the liability is assumed from a person who is a party to the suit or agreement, and the terms of the assignment satisfy certain requirements. Generally, these requirements are that (1) the periodic payments are fixed as to amount and time; (2) the payments cannot be accelerated, deferred, increased, or decreased by the recipient; (3) the assignee's obligation is no greater than that of the assignor; and (4) the payments are excludable by the recipient under section 104(a)(2) as damages on account of personal injuries or sickness. Present law provides a separate exclusion under section 104(a)(1) for the recipient of amounts received under workmen's compensation acts as compensation for personal injuries or sickness, but a qualified assignment under section 130 does not include the assignment of a liability to make such payments.

[15] A reinsurance contract is generally treated in the same manner as the contract being reinsured.

Description of Proposal

The bill (H.R. 1416) would extend the exclusion for qualified assignments under Code section 130 to amounts assigned for assuming a liability to pay compensation under any workmen's compensation act. The bill would require that the assignee assume the liability from a person who is a party to the workmen's compensation claim, and would require that the periodic payment be excludable from the recipient's gross income under section 104(a)(1) (rather than section 104(a)(2)), in addition to the requirements of present law.

Effective Date

The bill would be effective for workmen's compensation claims filed after the date of enactment.

3. Treatment of foreign insurance companies (H.R. 1228)

Present Law

A foreign company that is carrying on an insurance business in the United States generally is taxed in the same manner as a U.S. insurance company on its income that is effectively connected with its conduct of a U.S. trade or business. However, under section 842, the net investment income of a foreign insurance company that is effectively connected with the conduct of an insurance business in the United States may not be less than the minimum effectively connected net investment income (i.e., the product of the required U.S. assets of the company for the taxable year and the domestic investment yield applicable to the company for the taxable year). Section 842 was modified by the Omnibus Budget Reconciliation Act of 1987.

The required U.S. assets of a foreign insurance company for any year is the product of the mean of the company's total insurance liabilities on U.S. business and the domestic asset/liability percentage applicable to the company. Each year, the Treasury Department must prescribe a domestic asset/liability percentage applicable to foreign life insurance companies and a separate domestic asset/liability percentage applicable to foreign property and casualty insurance companies. The domestic asset/liability percentage for each type of insurance company equals the mean of the assets of the domestic companies of that type divided by the mean of the total insurance liabilities of the domestic companies of that type.

In addition, for each year, the Treasury Department must prescribe a domestic investment yield for foreign life insurance companies and a separate domestic investment yield for foreign property and casualty insurance companies. The domestic investment yield for each type of insurance company equals the net investment income of domestic companies of that type divided by the mean of the aggregate assets of the domestic companies of that type.

The Treasury Department determines the domestic asset/liability percentage and the domestic investment yield for each type of insurance company on the basis of data derived from a representative sample of domestic insurance companies. For any taxable year, the domestic asset/liability percentages and the domestic investment

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yields are based on data from the second preceding taxable year. The Treasury Department generally relies on data from the annual statements of the domestic insurance companies in making these determinations.

The Treasury Department is authorized to promulgate such regulations as may be necessary or appropriate to effectuate the purposes of Section 842, including regulations that provide proper adjustments in succeeding taxable years where the actual effectively connected net investment income of a foreign insurance company for any year exceeds the minimum effectively connected net investment income of such insurance company for such year.

Description of Proposal

Recomputation of effectively connected net investment income in subsequent taxable year

The bill (H.R. 1228) would provide that the effectively connected net investment income of a foreign insurance company for any taxable year would initially equal the actual effectively connected net investment income of the company for that taxable year. Subsequently, after the Treasury Department makes the requisite data available with respect to domestic insurance companies for that taxable year, a foreign insurance company would be required to compute its minimum effectively connected net investment income for that taxable year and to recompute its effectively connected net investment income for that taxable year. Any adjustments to income resulting from this recomputation would increase or decrease (as appropriate) the effectively connected net investment income for the second taxable year following the taxable year for which income is recomputed. Interest would also be charged (or paid) on any underpayment (or overpayment) resulting from the adjustment.

Cumulative determination of recomputed effectively connected net investment income

The recomputed effectively connected net investment income of a foreign insurance company for any taxable year would be determined on a cumulative basis. Thus, the recomputed effectively connected net investment income would equal the greater of (1) the cumulative actual effectively connected net investment income or (2) the cumulative minimum effectively connected net investment income, reduced by the recomputed effectively connected net investment income for all preceding taxable years.

Use of tax return data rather than annual statement data

The determination of the domestic asset/liability percentage and the domestic investment yield for any taxable year would be based on representative tax return data of U.S. insurance companies for such taxable year rather than annual statement data of U.S. insurance companies (unless such data is unavailable, in which case the Treasury Department may use such representative data as is considered appropriate).

Effective Date

The bill would apply as if originally included in the Omnibus Budget Reconciliation Act of 1987.

4. Treatment of certain pension business with respect to employees of charitable organizations

Present Law

Present law provides that an organization described in sections 501(c)(3) and (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance (sec. 501(m)). The activity of providing commercial-type insurance is treated as an unrelated trade or business but, in lieu of the usual tax on unrelated trade or business taxable income, the unrelated trade or business activity is taxed under the rules relating to insurance companies (subchapter L of the Code).

When this provision was enacted as part of the Tax Reform Act of 1986, a special grandfather rule provided that the provision did not apply to certain organizations, including Mutual of America, with respect to that portion of their business attributable to pension business. For this purpose, pension business means the administration of qualified pension plans, tax-sheltered annuities, unfunded deferred compensation plans of State and local governments, and individual retirement arrangements.

Description of Proposal

Under the proposal, if Mutual of America ceases to qualify as a tax-exempt organization for Federal income tax purposes, the special grandfather rule of present law would continue to apply, exempting from tax certain pension business. Such pension business would be that business attributable to organizations exempt from tax under subtitle A of the Code, to States or political subdivisions, or to agencies or instrumentalities thereof, provided that at least 50 percent of all the exempt organizations with respect to which Mutual of America has pension business during the taxable year have less than 30 employees and such employees have average annual compensation of less than $30,000 (with cost-of-living adjustments).

The proposal would provide that the special grandfather rule would be phased out ratably commencing with the second taxable year following the year in which Mutual of America ceases to qualify as a tax-exempt organization for Federal income tax purposes. In such second year, 80 percent of the pension business would remain exempt; in the third taxable year, 60 percent; the fourth taxable year, 40 percent; in the fifth taxable year, 20 percent; and in the sixth and subsequent taxable years, 0 percent.

Effective Date

The proposal would be effective on the date of enactment.

5. Treatment of certain capital gains and losses of a life insurance company

Present Law

A life insurance company is subject to tax on its life insurance company taxable income, which is its life insurance gross income reduced by life insurance deductions. If a life insurance company has a net capital gain for the taxable year, then its tax is the sum of (a) a partial tax on its life insurance company taxable income reduced by the amount of the net capital gain, and (b) the alternative tax imposed on the net capital gain of a corporation under section 1201(a) (sec. 801)).

In general, capital gain or loss means gain or loss from the sale or exchange of a capital asset (sec. 1222). In the case of a corporation (including a life insurance company), losses from sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges (sec. 1211). Section 1231 provides a special rule that net gains from sales or exchanges of depreciable property used in the trade or business and real estate held for more than a year and used in the trade or business are treated as capital, while net losses from sales or exchanges of such property are treated as ordinary.

In the case of a life insurance company, however, property used in a trade or business is treated as including only property used in carrying on an insurance business (sec. 818(b)). Section 818(b) further provides that for purposes of determining whether property is a capital asset, the sale or exchange of which gives rise to capital gain or loss, property used in the trade or business includes only property used in carrying on an insurance business. Thus, the gains or losses from the sale or exchange of real estate held for more than a year or depreciable property that is used in any noninsurance trade or business (e.g., renting real estate) are treated as gains or losses from the sales or exchanges of capital assets rather than (if losses exceed gains) ordinary gains and losses.

Description of Proposal

The rules of section 818(b) limiting property used in a trade or business to property used in carrying on an insurance business in the case of a life insurance company would be repealed. Thus, gains or losses from the sale or exchange of real estate held for more than one year or depreciable property that is used in either an insurance business or a noninsurance business of a life insurance company would be treated as ordinary gains and losses (if losses exceed gains), and as capital gains and losses (if losses do not exceed gains).

Effective Date

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

D. Pass-Through Entities

1. Treatment of certain large partnerships under the passive loss rules

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies with respect to credits from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.

The passive loss rule is applied separately with respect to items attributable to each publicly traded partnership (sec. 469(k)). Thus, net losses and credits of a partner from each publicly traded partnership are suspended and applied only against income from (or tax liability attributable to) that publicly traded partnership. Such suspended losses are allowed upon a complete disposition of the partner's interest in the partnership. A publicly traded partnership is one whose interests are (1) traded on an established securities market, or (2) readily tradable on a secondary market (or the substantial equivalent thereof).

Description of Proposal

H.R. 13, the Tax Simplification Act of 1993, would modify the tax treatment of a large partnership (generally, a partnership with at least 250 partners, or an electing partnership with at least 100 partners) and its partners. Under the bill, the taxable income of a large partnership would be computed in the same manner as that of an individual, except that certain specified items would be separately stated and certain modifications would be made. These modifications include disallowing the deduction for personal exemptions, the net operating loss deduction and certain itemized deductions. The ten types of items from a large partnership that would be separately stated include, among other items: (1) taxable income or loss from passive loss limitation activities; and (2) taxable income or loss from other activities (e.g., portfolio income or loss).

The proposal would modify the application of the passive loss rules to items from large partnerships under the provisions of H.R. 13. The proposal would extend present-law section 469(k) of the Code to newly-formed large partnerships; section 469(k) would thus apply to large partnerships as well as to publicly traded partnerships. Under the proposal, the passive loss rules would be applied separately with respect to items attributable to each large partnership (sec. 469(k)). Net losses and credits of a partner from each such partnership would be suspended and applied only against income from (or tax liability attributable to) that large partnership.

Such suspended losses would be allowed upon a complete disposition of the partner's interest in the large partnership.

Effective Date

The proposal would have the same effective date as the large partnership reporting provisions of H.R. 13 (i.e., partnership taxable years ending on or after December 31, 1993).

2. Family S corporations

Present Law

A small business corporation meeting certain requirements may elect to be treated as an S corporation. Income and losses of an S corporation generally are passed through to its shareholders and taxed at the shareholder level. A small business corporation may not have more than 35 shareholders. For this purpose, a husband and wife (and their estates) are counted as one shareholder.

Description of Proposal

Under the proposal, the 35-shareholder limit would not apply if all the stock of the corporation were held by members of the same family. A family would be defined as the lineal descendants of a common ancestor (and their spouses and former spouses). The common ancestor could not be more than four generations removed from the youngest generation of shareholder at the time the S election is made.

Effective Date

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

3. Certain trusts eligible to hold stock in S corporations

Present Law

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

Description of Proposal

In general

The proposal would allow stock in an S corporation to be held by certain trusts ("electing small business trusts"). In order to qualify for this treatment, all beneficiaries of the trust would have to be individuals or estates, except that charitable organizations could hold contingent remainder interests. No interest in the trust could be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under section 1012). Thus, interests in the trust would have to be acquired by reason of gift, bequest, etc.

A trust would have to elect to be treated as an electing small business trust. An election would apply to the taxable year for which made and could be revoked only with the consent of the Secretary of the Treasury or his delegate.

Each potential current income beneficiary of the trust would be counted as a shareholder for purposes of the 35-shareholder limitation (or, if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Where the trust disposes of all the stock in an S corporation, any person who first became so eligible during the 60 days before the disposition would not be treated as a potential current beneficiary.

A qualified subchapter S trust with respect to which an election is in effect, and an exempt trust, would not be eligible to qualify as an electing small business trust.

Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations would be treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust would be taxed at the highest individual rate (39.6 percent assuming enactment of the Revenue Reconciliation Act of 1993 as passed by the House) on this portion of the trust's income. The taxable income attributable to this portion includes (1) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses would be allowed only to the extent of capital gains.

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

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

Treatment of remainder of items held by trust

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

Effective Date

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

4. Modifications to S corporation rules

a. Shareholder limitations for S corporations

Present Law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35-shareholders; (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" is any corporation which is a member of an affiliated group, certain financial institutions, certain insurance companies, a section 936 corporation, or a DISC or former DISC.

Description of Proposal

The proposal would make the following changes to the shareholder limitations imposed upon S corporation eligibility:

(1) The number of eligible shareholders would be increased from 35 to 50.[16]

(2) A tax exempt organization would be allowed to be a shareholder in a small business corporation. Items of income or loss of an S corporation would flow through to the tax exempt organization for purposes of the unrelated business income tax applicable to such organizations.[17]

(3) A nonresident alien would be allowed to be a shareholder in a small business corporation. Any effectively-connected U.S. income allocable to the nonresident alien would be subject to a withholding tax.[18]

(4) The types of trusts eligible to be a shareholder in a small business corporation would be expanded. Single-tier trusts would be permitted to have multiple income beneficiaries and to accumulate income from the S corporation at the trust level. Spray trusts would be treated as eligible S corporation shareholders. Multiple beneficiaries would each, along with the trust, be treated as share-

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[16] This provision was included in H.R. 11 (102nd Cong.), as passed by the Congress and vetoed by President Bush in 1992.

[17] Similar rules apply to tax exempt organizations that are partners in partnerships under present law.

[18] Similar rules apply to nonresident aliens that are partners in partnerships under present law.

holders. However, family attribution rules (as described below) would apply in counting the number of shareholders.[19]

(5) For purposes of the number of shareholder limitation, all family members would be treated as one shareholder. Family attribution rules would be determined pursuant to rules similar to those in present-law section 267(c)(4).[20]

Effective Date

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

b. Requirement that an S corporation have one class of stock

Present Law

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

Description of Proposal

The proposal would make the following changes to the one class of stock rule applicable to S corporations:

(1) A small business corporation would be permitted to issue certain preferred stock. In general, such stock would be stock that is not convertible and does not participate in corporate growth to any significant extent. Only eligible S corporation shareholders would be allowed to own preferred stock.

(2) The definition of "straight debt" would be expanded to include convertible debt.

(3) The definition of "straight debt" would be expanded to include debt held by creditors other than individuals.

Effective Date

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

c. S corporation permitted to hold subsidiaries

Present Law

A small business corporation eligible to be an S corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations).[21] In addi-

[19] A fuller explanation of a similar proposal is described in Part D.3. of this pamphlet.

[20] A fuller explanation of a similar proposal is described in Part D.2. of this pamphlet.

[21] A provision that was included in H.R. 11 (102nd Cong.), as passed by the Congress and vetoed by President Bush in 1992, would have allowed an S corporation to own 80 percent or more

Continued

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

Description of Proposal

An S corporation would be allowed to own 100 percent of another S corporation, as well as a chain of S corporations. The corporate group would not be allowed to file a consolidated return.

Effective Date

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

d. Treatment of shareholder guarantees of S corporation debt

Present Law

The amount of loss from an S corporation that a shareholder may take into account cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the unadjusted basis in any indebtedness of the corporation to the shareholder. Generally, a guarantee by a shareholder of a debt of an S corporation does not create adjusted basis for the shareholder.[22]

A partner in a partnership may include his or her share of partnership indebtedness in his or her basis in the partnership for purposes of determining the amount of deductible loss that flows through from the partnership.

Description of Proposal

The proposal would allow a shareholder of an S corporation to reflect debt of the corporation that is personally guaranteed by the shareholder as part of his or her adjusted basis in the corporation for loss deduction purposes.

Effective Date

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

e. Treatment of passive investment income

Present Law

An S corporation is subject to corporate-level tax (at the highest marginal corporate tax rate) on its net passive income if the corporation has subchapter C earnings and profits[23] at the close of the taxable year and has gross receipts more than 25 percent of which is passive investment income.

of a C corporation. This provision also is included in H.R. 13, the "Tax Simplification Act of 1993," introduced by Chairman Rostenkowski on January 5, 1993.

[22] See, *Blum v. Comm.*, 59 T.C. 436 (1972); *Leavitt V. Comm.*, 90 T.C. 206 (1988); *Calcutt v. Comm.*, 91 T.C. 14 (1988); *Erwin v. Comm.*, 56 TCM 1343 (1989). Cf., *Selfe v. U.S.*, 778 F. 2d 769 (11th Cir. 1985).

[23] An S corporation generally will have subchapter C corporation earnings and profits if it had been a C corporation prior to electing to be an S corporation.

In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which is passive investment income.

For these purposes, "passive investment income" generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). "Passive investment income" generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, or gain or loss from any section 1256 contract (or related property) of an options or commodity dealer.[24] "Net passive income" is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of the income.

Description of Proposal

The proposal would eliminate the rule that terminates an S corporation election if the corporation has subchapter C earnings and profits and excessive passive income for three consecutive years.

In addition, "passive investment income" generally would not include income earned from the active conduct of a trade or business. Whether or not income was earned from the active conduct of a trade or business would be determined by a facts and circumstances test.

Effective Date

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

f. Provide for automatic waiver of certain inadvertent terminations

Present Law

If the Internal Revenue Service (IRS) determines that a corporation's subchapter S election was terminated inadvertently, the IRS can waive the effect of the terminating event for any period if the corporation and shareholders timely agree to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling.

Description of Proposal

The proposal would direct the IRS to adopt an automatic waiver procedure so that an entity would not lose its S corporation status due to a terminating event of a "ministerial" nature. An example of such an event would include the failure of a trust beneficiary to make a qualified subchapter S trust election.[25]

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[24] See, Treas. reg. sec. 1.1362-2(c)(5).

[25] A provision that was included in H.R. 11 (102nd Cong.), as passed by the Congress and vetoed by President Bush in 1992, would have granted the Secretary of the Treasury the authority

Continued

Effective Date

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

g. Treatment of certain fringe benefits

Present Law

For fringe benefit purposes, an S corporation is treated as a partnership and any shareholder that owns two percent or more of the stock of the S corporation at any time during the year is treated as a partner.

A qualified deferred compensation plan of an S corporation is prohibited from making loans to shareholder-employees (and certain related persons) that own more than five percent of the S corporation stock. Should this prohibition be violated, the persons involved in the transaction may be subject to an excise tax.

Description of Proposal

For fringe benefit purposes, an S corporation would be treated as a C corporation rather than as a partnership.

In addition, the restriction on loans from qualified plans would be repealed.

Effective Date

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

h. Treatment of losses on liquidation of S corporation

Present Law

If an S corporation is liquidated, gain or loss on the property distributed in liquidation is measured at the corporate level (by comparing the fair market value of the property to its adjusted basis in the hands of the corporation) and flowed through to the shareholders. The character of such gain or loss is also determined at the corporate level so that, in some cases, ordinary gain or loss may be flowed through to shareholders. The gain increases the shareholders' adjusted bases in their stock. The shareholders then have individual-level gain or loss with respect to the property received (measured by comparing the fair market value of the property to the shareholders' adjusted bases in their stock). Such gain or loss generally is capital gain or loss. Thus, a shareholder of an S corporation may have ordinary gain and a capital loss upon the liquidation of an S corporation.

Description of Proposal

Loss recognized by a shareholder in complete liquidation of an S corporation would be treated as ordinary loss to the extent the shareholder's adjusted basis in the S corporation stock is attrib-

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to treat certain invalid elections as effective. This provision also is included in H.R. 13, the "Tax Simplification Act of 1993," introduced by Chairman Rostenkowski on January 5, 1993.

utable to ordinary income that was recognized as a result of the liquidation.

Effective Date

The proposal would be effective for liquidations occurring after the date of enactment.

i. Treatment of certain losses carried over under the at-risk rules

Present Law

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

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

Description of Proposal

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

Effective Date

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

j. Extend period that a testamentary trust may hold S corporation stock

Present Law

A qualified testamentary trust is permitted to be a shareholder of an S corporation for a period not to exceed 60 days following the death of an S corporation shareholder. The 60-day period may be extended to 2 years if the entire corpus of the trust is includible in the gross estate of the deemed owner of the trust.

Description of Proposal

The 60-day period applicable to testamentary trusts would be extended to be a 2-year period.

Effective Date

The proposal would be effective for decedents dying after the date of enactment.

k. Permit consent dividends to bypass the accumulated adjustments account

Present Law

The accumulated adjustments account (AAA) of an S corporation generally is the amount of undistributed earnings of the S corporation that have been subject to shareholder-level tax. If an S corporation with both AAA and C corporation earnings and profits makes a distribution to shareholders, the amount of the distribution is deemed to first reduce the AAA. An S corporation may, with the consent of all its affected shareholders, elect to have all distributions made during a taxable year bypass the AAA. Proposed Treasury regulation section 1.1368-1(f)(3) allows the election to apply to deemed dividends.

Description of Proposal

The proposed Treasury regulation allowing the election to bypass the AAA to apply to deemed dividends would be codified.

Effective Date

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

l. Allow interim closing of the books of termination of shareholder interest with consent of corporation and affected shareholders

Present Law

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

Description of Proposal

The election to close the books of the S corporation upon the termination of a shareholder's interest would be made by the corporation and all shareholders that would be affected by the election, rather than by all shareholders.

Effective Date

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

m. Expand the post-termination period

Present Law

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

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

Description of Proposal

The present-law post-termination period of 120 days would be extended.

Effective Date

The proposal would be effective for post-termination periods beginning after the date of enactment.

5. Treatment of safe-harbor leases of membership organizations

Present Law

Safe harbor leases

The Economic Recovery Tax Act of 1981 provided rules intended to permit full utilization of tax benefits. Under these rules (known as the "safe harbor lease rules"), the putative "lessor" in the transaction was treated as the property owner for Federal income tax purposes (regardless of the transaction's economic substance) and thereby was entitled to cost recovery deductions and investment tax credits. Thus, a person (i.e., lessee) who complied with these rules could, by entering into a nominal sale and safe-harbor leaseback, effectively sell some of the tax benefits associated with the property, while retaining the benefits and burdens of ownership. The safe harbor lease rules were repealed by the Tax Equity and Fiscal Responsibility Act of 1982.

Deductions of membership organizations

Under section 277, membership organizations (such as a cooperative) may not offset losses from transactions with members against income from transactions with nonmembers. The Internal Revenue Service has taken the position that the interest income derived by a membership organization from a safe-harbor lease transaction is income not derived from transactions with members while the rental expense from such a safe-harbor lease transaction must be allocated between income derived from members and income derived from nonmembers. (See, e.g., PLR 9214009 (December 13, 1991).)

Description of Proposal

The interest income and rental expense from the sale and leaseback of property by a membership organization under a safe-harbor lease would be netted and any difference would be allocated between members and nonmembers in proportion to the business done with each group.

Effective Date

The proposal would be effective for all taxable years beginning before, on, or after the date of enactment.

E. Cost Recovery Provisions

1. Depreciation of semi-conductor manufacturing equipment

Present Law

In general, tangible depreciable property placed in service after 1986 is depreciated under the modified Accelerated Cost Recovery System (MACRS) enacted as part of the Tax Reform Act of 1986. MACRS includes a general depreciation system as well as an alternative depreciation system.

Under the general MACRS rules, depreciable property is divided into nine classes (3-year property, 5-year property, 7-year property, 10-year property, 15-year property, 20-year property, 27.5-year residential rental property, 31.5-year nonresidential real property and 50-year railroad grading or tunnel bores). An asset generally is placed into a property class based upon its class life. The 200-percent declining balance method of depreciation is used for 3-year, 5-year, 7-year, and 10-year property; the 150-percent declining balance method for 15-year and 20-year property and any property used in a farming business; and the straight-line method for other property.

In general, MACRS deductions are reduced for property under the alternative depreciation system by calculating depreciation using the straight-line method over the property's class life. A property's class life generally corresponds to its Asset Depreciation Range (ADR) midpoint life and often is longer than the recovery period applicable to the general MACRS. (The class lives and recovery periods of some assets are set by statute, regardless of the asset's ADR midpoint life.) The alternative depreciation system applies to foreign use property, tax-exempt use property, tax-exempt bond financed property, certain imported property, and property to which the taxpayer so elects and is used to compute corporate earnings and profits. The class lives of the alternative depreciation system are used for purposes of the corporate and individual alternative minimum tax.

The applicable recovery period for semi-conductor manufacturing equipment is five years for both the general MACRS depreciation system and the alternative depreciation system.

Description of Proposal

Semi-conductor manufacturing equipment would be classified as 3-year property for purposes of the general MACRS depreciation system and the alternative depreciation system.

Effective Date

The proposal would apply to property placed in service after the date of enactment.

2. Depreciation of helicopters used in timber management and harvesting

Present Law

Helicopters have an ADR midpoint life of six years. Thus, as described in more detail in the description of present law for Item D.1., above, helicopters have an applicable recovery period of five years for purposes of the MACRS general depreciation system and a class life of six years for purposes of the alternative depreciation system.

Description of Proposal

The proposal would provide that any helicopter used predominantly in timber management and harvesting would be classified as 3-year property for purposes of the MACRS general depreciation system. The class life under the alternative depreciation system would be four years.

Effective Date

The proposal would apply to property placed in service after May 5, 1993.

3. Allow passenger vessels used in domestic trade to qualify for Merchant Marine Capital Construction Fund

Present Law

In determining taxable income for regular tax purposes, a qualified taxpayer who owns or leases a qualified vessel is allowed a deduction for certain amounts contributed to a fund established under section 607 of the Merchant Marine Act, 1936 (a "capital construction fund"). In addition, the investment earnings on amounts contributed to a capital construction fund are excluded from gross income for regular tax purposes.

If a withdrawal from a capital construction fund is used to acquire, construct, or reconstruct a qualified vessel, the amount withdrawn generally is not included in gross income and the basis of the qualified vessel generally is reduced by the amount withdrawn to the extent attributable to amounts previously deducted or excluded from income. In the case of any other withdrawal from a capital construction fund, the amount withdrawn generally is included in gross income to the extent attributable to amounts previously deducted or excluded from income and interest on the tax liability attributable to such inclusion generally must be paid from the date of the deduction or exclusion.

A qualified vessel generally is any vessel constructed or reconstructed in the United States and documented under the laws of the United States. In addition, the person maintaining the capital construction fund must agree with the Secretary (of Commerce or Transportation) that the vessel will be operated in the United States foreign trade, Great Lakes trade, or noncontiguous domestic trade or in the fisheries of the United States.

Description of Proposal

The definition of qualified vessel would be amended to include passenger vessels used in domestic trade.

Effective Date

The proposal would be effective for vessels acquired, constructed, or reconstructed after December 3, 1992.

4. Treatment of automobiles and computers under the alternative minimum tax

Present Law

A taxpayer is subject to an alternative minimum tax (AMT) to the extent that the taxpayer's tentative minimum tax exceeds the taxpayer's regular income tax liability. A taxpayer's tentative minimum tax generally equals 20 percent (24 percent in the case of an individual) of the taxpayer's alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income (AMTI) is the taxpayer's taxable income increased by certain tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items.

One of the adjustments which is made to taxable income to arrive at AMTI relates to depreciation. For AMT purposes, depreciation on most personal property to which the modified Accelerated Cost Recovery System (MACRS) adopted in 1986 applies is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the property's class life. The class lives of MACRS property generally are longer than the recovery periods allowed for regular tax purposes.

For taxable years beginning after 1989, the AMTI of a corporation is increased by an amount equal to 75 percent of the amount by which adjusted current earnings (ACE) of the corporation exceed AMTI (as determined before this adjustment). In general, ACE means AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. For purposes of ACE, depreciation is computed using the straight-line method over the class life of the property. Thus, a corporation generally must make two depreciation calculations for purposes of the AMT—one using the 150-percent declining balance method over the class life and another using the straight-line method over the class life.[26]

The recovery period for regular tax purposes and the class life for AMT purposes for (1) computers and related peripheral equipment and (2) automobiles and light general purpose trucks are the same and are set at five years. For regular tax purposes, depreciation on

[26] A provision in H.R. 2264 (Omnibus Budget Reconciliation Act of 1993), as passed by the House on May 27, 1993, would eliminate the depreciation component of the ACE adjustment. Under the bill, taxpayers, including individuals, generally would compute AMT depreciation by using the 120-percent declining balance method over the recovery periods applicable for regular tax purposes for property placed in service after 1993.

such equipment is calculated using the 200-percent declining balance method.

Description of Proposals

For AMT purposes, taxpayers would compute depreciation for computers and related peripheral equipment by using the 200-percent declining balance method over a five-year period. In addition, no adjustment would be required for ACE purposes for such property.

Under a separate proposal, the same AMT depreciation treatment described in the above paragraph would apply to automobiles and light general purpose trucks.

Effective Date

The proposals would be effective for property placed in service after 1993.

5. Increase expensing for passenger automobiles

Present Law

In general

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense and deduct up to $10,000 of the cost of qualifying property placed in service for the taxable year under section 179.[27] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $10,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Limitations with respect to passenger automobiles

An automobile used in a trade or business generally qualifies for expensing under section 179. However, section 280F of the Code provides that the combination of the taxpayer's section 179 deduction and depreciation deduction cannot exceed $2,560 for the year a passenger automobile is placed in service. Depreciation deductions for subsequent years are limited as follows under section 280F: $4,100 for the second year; $2,450 for the third year; and $1,475 for each succeeding year. These dollar amounts are indexed for inflation. Since the first-year depreciation deduction for an automobile costing $12,800 is $2,560, taxpayers are effectively precluded from claiming any section 179 deduction for passenger auto-

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[27] A provision in H.R. 2264 (Omnibus Budget Reconciliation Act of 1993), as passed by the House on May 27, 1993, would increase the $10,000 amount allowed to be expensed under section 179 to $25,000 for property placed in service in taxable years beginning after December 31, 1992.

mobiles costing $12,800 or more (determined before the inflation adjustment).

Description of Proposal

In the case of any passenger automobile used in a trade or business, the amount that a taxpayer would be allowed to expense and deduct under section 179 would be limited to the lesser of: (1) the amount allowed to be expensed under section 179 (a maximum of $10,000 under present law), or (2) the maximum amount of depreciation deductions allowed during the recovery period under section 280F ($12,798 before the inflation adjustment). Any remaining basis after the application of the expensing allowance would become deductible as depreciation starting in the second year of the recovery period (subject to the special section 280F limitation of $1,475 per year, determined before the inflation adjustment).

For example, assume a taxpayer purchases a passenger automobile for $21,000 and uses it in his trade or business. Under the proposal, the taxpayer would be allowed to deduct $10,000 in the year the automobile is placed in service (assuming the section 179 limitation is $10,000 as under present law and the taxpayer is not subject to the phase-out). The taxpayer would be allowed to deduct $1,475 (plus the applicable inflation adjustment) in each subsequent year until the remaining basis of $11,000 is recovered.

Effective Date

The proposal would be effective for property placed in service in taxable years beginning after 1993.

6. Treatment of leasehold improvements to nonresidential real property

Present Law

A taxpayer is allowed to recover, through annual depreciation allowances, the cost or other basis of nonresidential real property (other than land) that is used in a trade or business or that is held for the production of rental income. For regular tax purposes, the amount of the depreciation deduction allowed with respect to nonresidential real property for any taxable year generally is determined by using the straight-line method and a recovery period of 31.5 years (sec. 168(b)(3) and (c)).[28] No special class or recovery period is provided with respect to additions or improvements to property (sec. 168(i)(6)), or with respect to leasehold improvements (sec. 168(i)(8)). In the case of lessee leasehold improvements, on termination of the lease, a lessee who does not retain the improvements computes gain or loss by reference to the adjusted basis of the improvements at that time.

Description of Proposal

The proposal would modify the depreciation deduction allowable with respect to nonresidential real property by establishing an ad-

[28] Section 14151 of H.R. 2264 (Omnibus Budget Reconciliation Act of 1993), as passed by the House on May 27, 1993, would increase this recovery period to 39 years.

ditional class of property, qualified renovation property, with a recovery period of 15 years. The depreciation deduction with respect to qualified renovation property would be determined by using the straight-line method and a mid-month convention. Qualified renovation property generally would include the renovation of the interior of a building that is nonresidential real property, except that it would not include renovation: (1) of a building that was placed in service by the taxpayer less than 3 years before the renovation is placed in service; (2) of the internal structural framework of the building; (3) the expenditure for which qualifies for any credit; (4) attributable to the enlargement of a building; or (5) of space not exclusively used by a tenant. Present-law rules relating to the depreciation of real property would apply to the depreciation of qualified renovation property (e.g., recapture rules).

Effective Date

The proposal would be effective for property placed in service after December 31, 1993.

F. Employee Benefits Provisions

1. Taxation of veterans' benefits (H.R. 786)

Present Law

Section 134 of the Code (as added by the Tax Reform Act of 1986) provides that qualified military benefits are excludable from gross income. In general, a qualified military benefit is an allowance or in-kind benefit received by a member of former member of the uniformed services of the United States (or their spouses or dependents) and which was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice.

In 1992, the Treasury Department stated in a letter that the following veterans' benefits are excludable from income: income arising from VA home mortgage debt waivers and similar debt waiver programs; disability-related payments, including all cost-of-living adjustments that have been made since 1986; and all in-kind benefits provided by the VA as of September 9, 1986, regardless of any subsequent modifications to those benefits.

Description of Proposal

The bill (H.R. 786) would provide that any allowance or benefit administered by the Secretary of Veterans' Affairs is excludable from gross income.

Effective Date

The bill would be effective for taxable years beginning on or after January 1, 1984.

2. Benefits of retired military personnel serving as instructors in the Junior Reserve Officers' Training Corps (H.R. 736)

Present Law

Section 134 of the Code (as added by the Tax Reform Act of 1986) provides that qualified military benefits are excludable from gross income. In general, a qualified military benefit is an allowance or in-kind benefit received by a member or former member of the uniformed services of the United States (or their spouses or dependents) and which was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice.

In 1992, the Treasury Department stated in a letter that the following veterans' benefits are excludable from income: income arising from VA home mortgage debt waivers and similar debt waiver programs; disability-related payments, including all cost-of-living adjustments that have been made since 1986; and all in-kind benefits provided by the VA as of September 9, 1986, regardless of any subsequent modifications to those benefits.

Retired military personnel are authorized to serve as administrators or instructors in the Junior Reserve Officers' Training Corps (JROTC). Section 2031(d)(2) of title 10 of the United States Code provides that retired military personnel serving in such a capacity are not considered to be on active duty or inactive duty training for any purpose.

Description of Proposal

The bill (H.R. 736) would provide that section 134 of the Code is to be applied without regard to section 2031(d)(2) of title 10 of the United States Code. Thus, allowances paid to retired military personnel serving as JROTC instructors or administrators would be included in the section 134 definition of qualified military benefits.

Effective Date

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

3. Nondiscrimination rules not to apply to State judicial pension plans

Present Law

A plan of deferred compensation that meets the qualification requirements of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred.

The qualification standards and related rules are designed to ensure that qualified plans benefit an employer's rank and file employees as well as highly compensated employees. These standards and rules also define the rights of plan participants and beneficiaries and provide some limit on the tax benefits received under qualified plans. With certain exceptions, the qualification requirements apply to governmental plans as well as plans maintained by private employers.

One of the qualification requirements is that contributions or benefits provided under the plan not discriminate in favor of highly compensated employees (sec. 401(a)(4)). Qualified plans must also satisfy a minimum participation rule (sec. 401(a)(26)). Under this rule, a plan is not qualified unless it benefits the lesser of 50 employees of the employer or 40 percent or more of all employees of the employer. Certain employees are excluded in determining whether this rule is satisfied. The minimum participation rule can be satisfied on a separate line of business basis.

Another qualification requirement is that the plan meets certain coverage requirements (sec. 410(b)). These requirements are designed to ensure that the plan benefits a minimum number of rank-and-file employees and not just highly compensated employees. Governmental plans are subject to the coverage rules in effect before the enactment of the Employee Retirement Income Security Act of 1974 (ERISA). Those rules generally require that a qualified plan must cover either (1) a specified percentage of all employees (generally, 70 percent of all employees, or 80 percent of those eligible to benefit under the plan if at least 70 percent of all employees are eligible), or (2) such employees as qualify under a classification which is found by the Internal Revenue Service not to discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees. Certain employees are disregarded in applying the percentage tests.

Description of Proposal

The proposal would exempt judicial retirement plans from the general nondiscrimination rule of section 401(a)(4), the minimum participation rule, and the minimum coverage rules.

A judicial retirement plan would be defined to mean a plan or any portion of a plan established and maintained for its employees by the government of any State or political subdivision thereof (and their agencies and instrumentalities) and which provides for participation, coverage, contributions, or benefits which are primarily for judges or justices appointed or elected in accordance with the constitution and laws of such State, political subdivision, agency or instrumentality.

Effective Date

The proposal would be effective for years beginning on or after the date of enactment. In addition, judicial plans would be treated as meeting the provisions of law amended by the proposal for years beginning before the date of enactment.

4. Application of basis recovery rules in the case of a refund feature

Present Law

Under present law, a taxpayer is required to include in income a portion of each annuity payment received on or after the annuity starting date. Each payment generally is treated, in part, as a return of the taxpayer's investment in the contract (i.e., basis) and, in part, as gross income. The portion of each payment treated as a return of the taxpayer's investment in the contract is that amount that bears the same ratio to each payment as the taxpayer's total investment in the contract bears (as of the annuity starting date) to the total expected payments over the period of the annuity (as of such date). This amount is referred to as the exclusion ratio.

Present law limits the total amount that a taxpayer may exclude from income to the total amount of the taxpayer's investment in the contract. In addition, if payments cease under the annuity prior to the time that the investment in the contract has been fully recovered (i.e., because of the death of the taxpayer), then the taxpayer is allowed to deduct for his or her last taxable year the amount of unrecovered investment in the contract. For purposes of the provisions relating to net operating losses, the deduction is treated as related to a trade or business of the taxpayer.

Under present law, investment in the contract is the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amounts previously received under the contract that were excluded from gross income. In addition, investment in the contract is reduced by certain payments in the nature of a refund of the consideration paid. These payments in the nature of a refund of consideration paid are referred to as refund features.

Description of Proposal

Under the proposal, the adjustment to the investment in the contract for a refund feature would apply only for purposes of determining the exclusion ratio. Thus, for purposes of calculating the total amount that may be excluded from income and determining the amount of any deduction if annuity payments cease before all investment in the contract has been recovered, the investment in the contract would be determined without regard to the refund feature.

Effective Date

In the case of the deduction with respect to a taxpayer who has died before recovering all investment in a contract, the proposal would be effective with respect to decedents dying on or after the date of enactment. In all other cases, the proposal would be effective with respect to annuity payments received after December 31, 1993.

5. Treat ESOPs as charitable organizations for purposes of transferring stock in a closely held corporation (H.R. 1807)

Present Law

Employee stock ownership plans.—An employee stock ownership plan (ESOP) is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan under which employer securities are held for the benefit of employees. The securities, which are held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts). Gains realized on the sale of employer securities to an ESOP are generally taxed at capital gains rates.

Charitable remainder trusts.—A deduction is allowed for Federal estate tax purposes for transfers by a decedent to charitable, religious, scientific, etc. organizations (Code sec. 2055(a)). In the case of a transfer of a remainder interest to a charity, the remainder interest must be in a charitable remainder trust (Code sec. 2055(e)). A charitable remainder trust generally is a trust that is required to pay, no less often than annually, a fixed dollar amount (charitable remainder annuity trust) or a fixed percentage of the fair market value of the trust's assets determined at least annually (charitable remainder unitrust) to noncharitable beneficiaries, and the remainder of the trust (i.e., after termination of the annuity or unitrust amounts) to a charitable, religious, scientific, etc. organization (Code sec. 664).

Description of Proposal

The bill (H.R. 1807) would permit certain limited transfers of qualified employer securities by charitable remainder trusts to ESOPs without adversely affecting the status of the charitable remainder trusts under Code section 664. As a result, the proposal would provide that a gratuitous transfer of employer securities to an ESOP would be deductible from the gross estate of a decedent under Code section 2055 to the extent of the present value of the remainder interest.

Qualified employer securities would include only employer securities (within the meaning of sec. 409(l) of the Code), which are issued by a domestic corporation that has no outstanding stock that is readily tradable on an established securities market. Stock would be qualified employer securities only if the stock first passes to the trust from the decedent.

No deduction would be permitted under section 404 of the Code with respect to securities transferred from the charitable remainder trust. The nondiscrimination requirements (sec. 401(a)(4)) normally applicable to qualified plans would be required to be satisfied with respect to the securities transferred. The ESOP would be required to treat the securities transferred as employer securities, except for purposes of determining the amount of deductible contributions to the plan otherwise permitted by the employer. The ESOP would be required to allocate the transferred securities up to the limit on contributions and benefits (sec. 415) after allocating any other employer contributions for the year; any transferred securities that could not be allocated because of the section 415 limits would be held in a suspense account and allocated in the same manner in subsequent years. Further, securities transferred to an ESOP by a charitable remainder trust could not be allocated to the account of (1) any family member of the decedent, or (2) any employee owning more than 5 percent of any class of outstanding stock of the corporation issuing the securities (or a member of a controlled group of corporations) or the total value of any class of outstanding stock of any such corporation.

Under the bill, an excise tax would apply if the employer securities transferred to an ESOP in a gratuitous transfer are disposed of during the 3-year period after the date on which the transfer occurs.

Effective Date

The bill would apply to transfers made to trusts to, or for the use of, an ESOP after the date of enactment.

6. Excise tax on nondeductible contributions

Present Law

Under present law, the maximum amount an employer can deduct in a year for contributions to all tax-qualified plans maintained by the employer generally is the greater of (1) 25 percent of the compensation paid or accrued to the beneficiaries under such plans or (2) the amount contributed to defined benefit pension plans in order to satisfy the minimum funding requirements with respect to such plans. In the case of a plan with more than 100 participants for the year, the maximum amount deductible is the greater of (1) 25 percent of the compensation paid or accrued to the beneficiaries under the plans or (2) the amount contributed to defined benefit pension plans of the employer up to the amount of unfunded current liability. Contributions that are not deductible can be carried forward indefinitely and deducted in subsequent years (subject to the general limits on deductibility). Contributions that are not deductible in the current year are subject to a 10 percent excise tax (sec. 4972).

Description of Proposal

The proposal would waive the 10-percent excise tax on certain contributions to a qualified cash or deferred arrangement (a section 401(k) plan) that are nondeductible because employer contributions are made to defined benefit plans (in excess of the amount necessary to meet the minimum funding requirements) to reduce or eliminate unfunded current liability existing as of the date of enactment. The excise tax waiver would apply only to contributions that do not exceed the excess of (1) the lesser of (a) the unfunded current liability as of the date of enactment of defined benefit pension plans maintained by the employer, (b) the amount contributed to such plans, or (c) 6 percent of the compensation of employees covered by the cash or deferred arrangement over (2) the amount necessary to satisfy the minimum funding requirement applicable to the defined benefit pension plans. The proposal would only apply to plans with more than 100 employees.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1992.

7. Leased employees

Present Law

Under present law, an individual (a leased employee) who performs services for another person (the service recipient) may be treated as the service recipient's employee if the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer. The individual is to be treated as the service recipient's employee only if the individual has performed services for the recipient on a substantially full-time basis for a period of at least 12 months, and the services are of a type historically performed by employees in the recipient's business field.

An individual who otherwise would be treated as a recipient's employee will not be treated as such an employee if the individual participates in a safe harbor plan maintained by the leasing organization. A plan is a safe harbor plan if it is a money purchase pension plan and if it provides that (1) an individual is a plan participant on the first day on which the individual becomes an employee of an employer maintaining the plan, (2) each employee's rights to or derived from employer contributions under the plan are nonforfeitable at the time the contributions are made, and (3) amounts are to be contributed by the employer on behalf of an employee at a rate not less than 10 percent of the employee's compensation for the year.

To be a safe harbor plan, a plan is required to cover all employees of the leasing organization (beginning with the date they become employees of the leasing organization) other than (1) employees who the leasing organization demonstrated to the satisfaction of the Secretary performed substantially all of their service for the leasing organization (and not service recipients) and (2) employees whose total compensation from the leasing organization is less than $1,000 during the plan year and during each of the 3 prior plan years.

An employee covered under a safe harbor plan is to receive the required allocation without regard to (1) the number of hours of service credited to the employee for the year, (2) whether the employee is employed by the leasing organization on any specified date during the year, and (3) the employee's age.

Each leased employee is to be treated as an employee of the service recipient, regardless of the existence of a safe harbor plan, if more than 20 percent of the service recipient's nonhighly compensated workforce are leased employees.

Description of Proposal

In general

The proposal would add a new safe harbor plan under the leased employee rules and make certain other changes to the rules.

Definition of safe harbor plan

In general

Under the proposal, a leased employee would not be treated as an employee of the service recipient if the employee is covered by a plan which is maintained by a qualified leasing organization and which provides certain benefit or contribution levels, provides that benefits vest at least as rapidly as under a specified schedule, and satisfies certain other requirements. The safe harbor would apply regardless of what percentage of the service recipient's nonhighly compensated workforce is comprised of leased employees.

Required benefits or contributions

If the safe harbor plan is a defined contribution plan, then each participant in the plan must receive an annual allocation of contributions and forfeitures equal to the maximum contribution permitted under the qualification rules.[29] If the plan is a defined benefit plan, then the plan must provide a benefit equal to the maximum benefit permitted under the qualification rules.[30] The benefit is to be accrued under the fractional method over 25 years of service. These contributions and benefits are determined without tak-

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[29] In the case of a defined contribution plan, the maximum permitted contribution is the lesser of (1) $30,000 or (2) 25 percent of the participant's compensation.

[30] The maximum benefit payable under a defined benefit plan cannot exceed the lesser of (1) $115,641 (indexed), or (2) 100 percent of the participant's average compensation for the highest 3 years.

ing into account contributions or benefits under social security or any other Federal or State law. The contribution and benefit requirements must be satisfied without regard to any minimum age or service requirements. Thus, for example, as under present law, in the case of a defined contribution plan, an employee covered under the plan is to receive the required allocation regardless of the number of hours of service credited to the employee for the year, regardless of whether the employee is employed by the leasing organization on any specified date during the year, and regardless of the employee's age.

Vesting requirements

In order to satisfy the vesting requirements, a safe harbor plan must provide that each participant has a nonforfeitable right to at least 30 percent of the participant's accrued benefits derived from employer contributions after 1 year of service, 50 percent after 2 years, 70 percent after 3 years, 85 percent after 4 years, and 100 percent after 5 years.

Other requirements

The plan must take into account service that could otherwise be disregarded under the break-in-service rules applicable to qualified plans (sec. 411(a)(4)(D)).

The proposal would permit an existing plan of a leasing organization to be merged into a safe harbor plan without preserving optional forms of benefit that are provided under the existing plan.

Definition of qualified leasing organization

A qualified employee benefit leasing organization would mean any organization which: (1) pursuant to a written agreement, fills job positions for a recipient which are not short term in duration and which are not for a defined period of time; (2) is registered with the Internal Revenue Service; (3) is not a member of a controlled group of corporations or an affiliated service group which includes a service recipient; (4) pays all payroll and related taxes and benefits costs from its own account and under its own name as the employer; (5) pays any premium required for worker's compensation programs or insurance from its own account and under its own name; and (6) allows the recipient to be responsible only for the direction of the operational duties of the assigned employees.

Leasing organization as sole employer

The proposal also would provide that in some circumstances for purposes of the leased employee rules a leasing organization is treated as the sole employer of a person who would otherwise be a leased employee. In order for this treatment to apply, the leasing organization must have the right to hire, terminate, and transfer the employee, pay the employee from its own accounts, direct, control and evaluate the manner and means of the employee's performance of services provided to the service recipient, be responsible for paying its employees regardless of receiving reimbursed payroll or fees from the service recipient, provide universal fringe benefits among its employees, bill the service recipient on a total fee basis rather than on a direct cost pass-through basis, not lease any substantial owner of the service recipient, and be the employee's common-law employer.

If the leasing organization is the sole employer of a leased employee under this rule, and the leasing organization maintains a plan for its employees with respect to which there is an accumulated funding deficiency, then the service recipient is liable for the excise tax on the accumulated funding deficiency.

Regulations

The Secretary of the Treasury would be directed to prescribe such regulations as are necessary to ensure prompt reporting and depositing of withholding and payroll taxes by qualified leasing organizations, including assigning a standard industry code to identify sole employer leasing organizations, establishing a procedure to register leasing organizations, and procedures for requiring only annual payroll tax reporting by service recipients using leasing organizations which are the sole employer of a leased employee.

Effective Date

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

8. Deferred compensation plans for volunteer fire and rescue personnel

Present Law

Under an eligible unfunded deferred compensation plan of a State or local government or tax-exempt employer, deferred compensation is included in gross income when it is paid or made available (sec. 457). In order for this treatment to apply, the plan must meet certain requirements. One of these requirements is that the maximum amount that can be deferred in any year is the lesser of $7,500 or 33-1/3 percent of compensation that is currently includible in gross income. One of the purposes of section 457 is to preclude employees of governmental and tax-exempt employers from deferring compensation while receiving minimal current taxable compensation.

If a deferred compensation arrangement of a State or local government or tax-exempt employer does not meet the requirements of an eligible unfunded deferred compensation plan, then the compensation is includible in gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation, and the tax treatment of any amount made available under the plan is determined under the rules relating to the taxation of annuities (sec. 72).

Deferred compensation is taken into account for social security tax purposes as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to the deferred compensation (sec. 3121(v)).

Description of Proposal

Under the proposal, any plan maintained by a State or local government or tax-exempt employer to pay retirement-type benefits to individuals who provide no services for the employer other than as volunteer fire and rescue personnel and who receive only minimal or no current compensation from the employer for such services would be treated as not providing for the deferral of compensation for purposes of section 457. Thus, benefits provided under such a plan would not be subject to the limits of section 457.

In addition, the proposal would provide that amounts payable under such a plan are not subject to social security taxes.

Effective Date

The proposal would be effective for contributions made or amounts received on or after the date of enactment.

9. "Qualified Football Coaches Plan Technical Corrections Act of 1993" (H.R. 1981)

Present Law

Under present law, a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries is treated as a qualified trust under section 401(a) of the Internal Revenue Code of 1986 (the Code) if certain requirements are satisfied. If a tax-qualified profit-sharing or stock bonus plan meets the requirements of a qualified cash or deferred arrangement, then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

A cash or deferred arrangement is not treated as a qualified cash or deferred arrangement if it is part of a plan maintained by (1) a State or local government or (2) any organization exempt from tax (sec. 401(k)(4)(B)).

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

Section 3(37) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended by Public Law 100-202 (Continuing Appropriations for Fiscal Year 1988), provides that, for purposes of Title I of ERISA, a qualified football coaches plan generally is treated as a multiemployer plan and may include a qualified cash or deferred arrangement. Under ERISA section 3(37), a qualified football coaches plan is defined as any defined contribution plan established and maintained by an organization described in section 501(c), the membership of which consists entirely of individuals who primarily coach football as full-time employees of 4-year colleges or universities, if the organization was in existence on September 18, 1986. This definition is generally intended to apply to the AFCA.

However, section 9343(a) of the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) provides that Titles I and IV of ERISA are not applicable in interpreting Title II of ERISA (the Code provisions relating to qualified plans), except to the extent specifically provided in the Code or as determined by the Secretary of the Treasury.

The Internal Revenue Service has determined that the cash or deferred arrangement maintained by the AFCA is not a qualified cash or deferred arrangement because the AFCA is a tax-exempt organization precluded under the Code from maintaining a qualified cash or deferred arrangement and that section 3(37) of ERISA does not apply in determining whether the Code's requirements are satisfied. In making this determination, the IRS also observed that the AFCA plan may also violate other provisions of the Code. For example, the Code requires that a qualified plan be maintained for the benefit of employees, but the coaches are not employees of the AFCA.

Description of Proposal

The bill (H.R. 1981) would amend Title II of ERISA to provide that, for purposes of determining the qualified plan status of a qualified football coaches plan, section 3(37) of ERISA is treated as part of Title II of ERISA and a qualified football coaches plan is treated as a multiemployer collectively bargained plan.

Effective Date

The bill would be effective for years beginning after December 22, 1987 (the date of enactment of Public Law 100-202).

10. Family and medical leave accounts

Present Law

Present law provides a number of different vehicles through which individuals can save on a tax-deferred basis, including individual retirement arrangements (IRAs), simplified employee pensions (SEPs), and employer-sponsored tax qualified pension plans. Within limits, contributions to these arrangements (and earnings thereon) are generally not includible in gross income until received. There are no limits on the purposes for which amounts distributed from such arrangements can be used. However, a 10-percent additional tax generally applies to distributions before age 59-1/2 (sec. 72(t)). In addition, in the case of certain tax-qualified pension plans, distributions from the plan can only be obtained after the occurrence of certain events, such as the attainment of normal retirement age, separation from service, or personal financial hardship. The Family and Medical Leave Act of 1993 requires certain employers to provide up to 12 weeks of leave for individuals with certain family and/or medical needs.

Description of Proposal

The proposal would permit employers to establish tax-favored family and medical leave accounts ("FMLAs") on behalf of their employees from which distributions would be made when the employee is on leave for certain health or family reasons.

Contributions to FMLAs, and the earnings thereon, would not be included in the employee's gross income until withdrawn. Contributions to FMLAs could be made either directly by the employer or through employee salary reduction. Direct employer contributions would not be subject to FICA and FUTA taxes, but salary reduction contributions would be. Annual contributions would be limited to the lesser of 50 percent of the employee's compensation (as defined in section 414(q)(7)) or $25,000.

Distributions could be made only by the employer, and only to the extent that the sum of the distribution and compensation actually received in the year does not exceed the compensation the individual would normally have received if the employee were not on leave. Distributions could only be made for qualified family or medical leave, when the employee dies or separates from service, or when the employee elects to discontinue participation in the plan. Qualified family or medical leave would mean leave due to a serious health condition of the employee, the need to care for the employee's child, spouse, or parent, or the need to care for newborn or newly adopted children (under the age of 6). The employer could require that the seriousness of the health condition must be certified by a health care provider (with second and, if necessary, third opinions available). Any amounts distributed would be included in gross income. If, for some reason, contributions exceed the cap in a particular year, the excess, including net earnings thereon, may be distributed, as long as the distribution occurs before the employee's tax return is due.

If an employee elects to discontinue participation in an FMLA, the balance of the account must be distributed. The employee cannot set up a new FMLA for a period of two years after such an election has been made. If the employee separates from employment, the account balance can be transferred, with no tax consequences, into a new FMLA of the new employer, if such transfer occurs within 180 days of the separation. If the transfer is not effected, the balance must be distributed to the employee. Such a distribution is includible in gross income, unless rolled over into an individual retirement plan. Finally, in the event of the death of the employee, the account balance must be distributed to the employee's designated beneficiaries, and is included in their gross income.

In order for the favorable tax treatment described above to apply, the FMLAs would have to be provided pursuant to a plan of the employer that meets certain requirements. All full-time employees (those working more than 17.5 hours per week) with at least one year of service must be eligible for the plan, and any matching contributions by employers in addition to salary reduction contributions must be given to all participants at the same rate. The plan must provide that, upon resumption of work, the employee is entitled to be restored to his or her initial position or an equivalent position. If the employee is covered under a group health plan by the employer prior to taking leave, this coverage must continue until the employee resumes work.

Effective Date

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

G. Individual Income Tax Provisions

1. Prohibition of fees assessed on employees who elect to receive the earned income tax credit on an advance basis

Present Law

Eligible low-income workers can claim a refundable earned income tax credit (EITC) of up to 18.5 percent of the first $7,750 of earned income for 1993 (19.5 percent for taxpayers with more than one qualifying child). The maximum amount of credit for 1993 is $1,434 ($1,511 for taxpayers with more than one qualifying child). This maximum credit is reduced by 13.21 percent of earned income (or adjusted gross income, if greater) in excess of $12,200 (13.93 percent for taxpayers with more than one qualifying child). The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $23,050. The maximum amount of earned income on which the EITC may be claimed, and the income threshold for the phaseout of the EITC, are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

Present law provides that the credit rates for the EITC increase in 1994, as shown in the following table.

Year	One qualifying child—		Two or more qualifying children—	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1993	18.5	13.21	19.5	13.93
1994 and after	23.0	16.43	25.0	17.86

The EITC can be received on an advance basis by a worker who elects to furnish a certificate of eligibility 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 is based on the amount of basic EITC allowable to a taxpayer with one qualifying child.

A supplemental young child credit is available to taxpayers with qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same income base as the ordinary EITC.

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

Description of Proposal

The proposal would prohibit employers from assessing any fee on employees who elect to file a certificate of eligibility, which is required for a taxpayer to claim the EITC on an advance payment basis.

Effective Date

The proposal would be effective for certificates filed after date of enactment.

2. Require employers to include earned income tax credit information with annual wage (W-2) statement

Present Law

Eligible low-income workers can claim a refundable earned income tax credit (EITC) of up to 18.5 percent of the first $7,750 of earned income for 1993 (19.5 percent for taxpayers with more than one qualifying child). The maximum amount of credit for 1993 is $1,434 ($1,511 for taxpayers with more than one qualifying child).

This maximum credit is reduced by 13.21 percent of earned income (or adjusted gross income, if greater) in excess of $12,200 (13.93 percent for taxpayers with more than one qualifying child). The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $23,050. The maximum amount of earned income on which the EITC may be claimed, and the income threshold for the phaseout of the EITC, are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

Present law provides that the credit rates for the EITC increase in 1994, as shown in the following table.

Year	One qualifying child—		Two or more qualifying children—	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1993	18.5	13.21	19.5	13.93
1994 and after	23.0	16.43	25.0	17.86

The EITC can be received on an advance basis by a worker who elects to furnish a certificate of eligibility to his or her employer.

A supplemental young child credit is available to taxpayers with qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same income base as the ordinary EITC.

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

Under present law, employers are required to inform employees with no income tax withheld that they may be eligible to receive the EITC. Many employers comply with this requirement by including such notice with the annual statement of wages (the W-2 form).

Description of Proposal

To increase taxpayer awareness of the EITC, employers would be required to notify workers with income below the eligibility levels for the EITC that they may be eligible to claim the EITC. This requirement could be met by including such notice with the employee's W-2 form.

Effective Date

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

3. Enhanced awareness of advance payment option of the earned income tax credit

Present Law

Eligible low-income workers can claim a refundable earned income tax credit (EITC) of up to 18.5 percent of the first $7,750 of earned income for 1993 (19.5 percent for taxpayers with more than one qualifying child). The maximum amount of credit for 1993 is $1,434 ($1,511 for taxpayers with more than one qualifying child).

This maximum credit is reduced by 13.21 percent of earned income (or adjusted gross income, if greater) in excess of $12,200 (13.93 percent for taxpayers with more than one qualifying child). The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $23,050. The maximum amount of earned income on which the EITC may be claimed, and the income threshold for the phaseout of the EITC, are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

Present law provides that the credit rates for the EITC increase in 1994, as shown in the following table.

Year	One qualifying child—		Two or more qualifying children—	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1993	18.5	13.21	19.5	13.93
1994 and after	23.0	16.43	25.0	17.86

The EITC can be received on an advance basis by a worker who elects to furnish a certificate of eligibility 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 is based on the amount of basic EITC allowable to a taxpayer with one qualifying child.

A supplemental young child credit is available to taxpayers with qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same income base as the ordinary EITC.

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

Description of Proposal

To increase taxpayer awareness of the advance payment option, which allows taxpayers to receive the EITC ratably over the entire year, rather than as a lump sum when the tax return is filed, the Internal Revenue Service would be directed to include notification of the advance payment option with refund checks sent to taxpayers who claim the EITC.

Effective Date

The proposal would be effective for refunds attributable to taxable years beginning after December 31, 1993.

4. Modify rule for construction workers' deduction for travel expenses paid or incurred in connection with employment lasting one year or more

Present Law

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs, and the cost of meals and lodging) are generally deductible, subject to the two-percent floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible.[31]

A taxpayer's employment away from home in a single location is generally treated as indefinite rather than temporary if it lasts for one year or more. Thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment. If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances. This rule is effective for costs paid or incurred after December 31, 1992, as a result of section 1938 of the Energy Policy Act of 1992 (Pub. L. 102-486).

[31] *Peurifoy v. Commissioner*, 358 U.S. 59 (1958), *aff'g* 254 F.2d 483 (4th Cir. 1957), *rev'g* 27 T.C. 149 (1957).

Prior to January 1, 1993, the following rules applied:

(1) If a taxpayer anticipated employment to last for less than one year, whether such employment was temporary or indefinite was determined on the basis of the facts and circumstances.

(2) If a taxpayer anticipated employment to last for one year or more and that employment did, in fact, last for one year or more, there was a presumption that the employment was not temporary but rather was indefinite, and that the taxpayer was not away from home during the indefinite period of employment. However, under certain circumstances, this one-year presumption of indefiniteness could have been rebutted where the employment was expected to, and did, last for one year or more, but less than two years.

(3) An expected or actual stay of two years or longer was considered an indefinite stay, regardless of any other facts and circumstances.[32]

Description of Proposal

In the case of taxpayers who are non-clerical and non-management employees in the construction industry, prior law would apply (i.e., the changes made by section 1938 of the Energy Policy Act of 1992 would not apply to these taxpayers). Alternatively, present law would apply to these taxpayers, except that the one-year period would be an eighteen-month period.

Effective Date

The proposal would be effective for costs paid or incurred after December 31, 1992.

5. "Fairness for Adopting Families Act" (H.R. 930)

Present Law

Under present law, no deduction is allowed with respect to the expenses associated with the legal adoption of a child.

Description of Proposal

Adoption expense deduction

The bill (H.R. 930) would permit a taxpayer to deduct from gross income up to $5,000 ($7,000, in the case of an international adoption) of qualified adoption expenses paid or incurred by the taxpayer with respect to the legal adoption of a single child under the age of 18 during a taxable year. The deduction would be phased out for taxpayers with taxable income (determined without regard to this deduction) between $60,000 and $70,000.

Qualified adoption expenses would include any reasonable and necessary adoption fees (including agency fees), court costs, attorney fees, and other expenses that directly relate to the legal adoption of a child by the taxpayer but only if such expenses are not incurred in violation of State or Federal law and the adoption has been arranged: (1) by a State or local agency with responsibility under State or local law for child placement through adoption; (2)

[32] Rev. Rul. 83-82, 1983-1 C.B. 45.

by a nonprofit, voluntary adoption agency authorized under State or local law to place children for adoption; or (3) through a private placement.

Qualified adoption expenses would not include expenses in connection with adopting a child of the individual's spouse or travel outside the United States unless the travel is required as a condition of the adoption by the country of the child's origin, to assess the health and status of the child, or to escort the child to the United States.

Adoption assistance programs

The bill would also provide an exclusion from income of an employee for up to $5,000 ($7,000, in the case of an international adoption) of qualified adoption expenses furnished pursuant to an adoption assistance program maintained by an employer provided (1) the plan benefits employees who qualify under a classification of employees that does not discriminate in favor of highly compensated employees, and (2) no more than 5-percent of the amounts paid or incurred by the employer during the year may be provided to more than 5 percent owners of the employer. The exclusion would be phased out over the same taxable income range as the adoption expense deduction. The amount excludible from income would be reduced by the amount of any deduction allowable with respect to the adoption.

Effective Date

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

6. Exclusion for certain overseas allowances received by certain Department of Defense personnel

Present Law

Civilian officers and employees of the State Department and Central Intelligence Agency (CIA) are exempt from tax on certain amounts received as allowances or otherwise (but not amounts received as post differentials) related to their overseas assignments (sec. 912(1)(A) and (B)). The benefits entitled to tax exemption are those set forth in chapter 9 of title I of the Foreign Service Act of 1980 (22 U.S.C. secs. 4081-4086), in the case of State Department officers and employees, and in section 4 of the Central Intelligence Agency Act of 1949, as amended (50 U.S.C. sec. 403e), in the case of CIA officers and employees. Such benefits may include loans of household effects, health care, payment of certain work-related entertainment and representational expenses, and the payment of certain travel and related expenses of employees and their families, including expenses for travel and moving to and from assigned posts of duty, and travel for home leave, medical care, family visits, and the evacuation of families from dangerous foreign areas.

Beginning with Intelligence Authorization Acts for fiscal years 1982 and 1984 (Pub. Laws No. 97-89 and 98-215), the law has provided that comparable benefits could be given to civilian Defense Department employees assigned to Defense Attache Offices and Defense Intelligence Agency Liaison Offices outside the United States

(10 U.S.C. sec. 1605) and to certain designated civilian and military Defense Department employees (generally National Security Agency personnel) assigned to special cryptologic activities outside the United States (section 9(b) of the National Security Agency Act of 1959, as amended (50 U.S.C. sec. 402 note)). The Code does not provide tax exemptions for these Defense Department employee benefits.

Description of Proposal

A tax exemption would be provided for those allowances and other items, comparable to the allowances and other items provided to civilian State Department and CIA employees, which are provided (under 10 U.S.C. sec. 1605 or sec. 9(b) of the National Security Agency Act of 1959, as amended) to civilian employees and officers of the Defense Department assigned to Defense Attache Offices and Defense Intelligence Agency Liaison Offices outside the United States, or to special cryptologic activities outside the United States, in cases where such allowances or other items would be exempt under current law if received by civilian State Department or CIA employees.

Effective Date

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

7. Choice of credit or deduction for interest on student loans (H.R. 1667)

Present Law

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

Description of Proposal

In general

The bill (H.R. 1667) would allow individuals who have paid interest on qualified education loans to choose either a deduction for such interest or a nonrefundable credit against regular tax liability generally equal to 15 percent of such interest, subject to a maximum credit of $300. Unused amounts of credit could not be carried forward or backward to other taxable years.

A qualified education loan generally would be any indebtedness[33] incurred to pay for qualified higher education expenses of the taxpayer or the taxpayer's spouse or dependents (within the definition of Code section 152) with respect to higher education institutions and certain area vocational education schools (i.e., eligible educational institutions defined in Code section 135(c)(3)) and institutions conducting internship or residency programs leading to

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[33] Indebtedness incurred by a student from borrowing from a related party (as defined in Code sections 267(b) and 707(b)(1)) would not be treated as a qualified education loan.

a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The qualified higher education expenses would have to be paid or incurred within a reasonable period of time before or after the indebtedness is incurred and would have to be attributable to education furnished during a period of time that the individual benefiting from the loan proceeds was at least a half-time student. Indebtedness that is used to refinance any indebtedness described in the previous sentence would also be treated as a qualified education loan.

Qualified higher education expenses would be defined as the student's cost of attendance.[34] At the time the expenses are incurred, the student would have to be the taxpayer or the taxpayer's spouse or dependent (as defined under Code section 152). Qualified higher education expenses taken into account for the purpose of this credit would be reduced by (1) amounts excluded from gross income under Code section 135 (relating to the redemption of United States savings bonds to pay for higher education expenses), and (2) the amount of the reduction described in section 135(d)(1) (relating to certain scholarships and veterans' benefits).

Deduction or credit claimed for interest on borrowing for expenses of taxpayer or spouse

In the case of qualified education loans used to pay the qualified higher education expenses of the taxpayer or the taxpayer's spouse, the credit or deduction would be allowed only with respect to interest paid on a qualified education loan that is allocable to the first 48 months during which interest accrued on the loan.[35]

Deduction or credit claimed for interest on borrowing for expenses of taxpayer's dependent

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

Phaseout of credit or deduction based on adjusted gross income

The amount of the otherwise allowable credit or deduction would be phased out ratably for taxpayers with adjusted gross income in the following ranges: $60,000-$90,000 for married individuals filing joint returns, $40,000-$55,000 for unmarried individuals, and $30,000-$45,000 for married individuals filing separate returns.

Limitations on claiming credit

No credit would be allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the tax-

[34] For purposes of the provision, "cost of attendance" would be defined as in section 472 of the Higher Education Act of 1965 as in effect on the day before the date of enactment of this provision (generally, tuition, fees, room and board, and related expenses).

[35] For purposes of counting the 48 months, any qualified education loan and all refinancing (that is treated a qualified education loan) of such loan would be treated as a single loan.

able year beginning in the calendar year in which such individual's taxable year begins.

No credit would be allowed for interest on any amount of education loan indebtedness for which a deduction is claimed under any other provision.

Limitations on claiming deductions

A taxpayer would not be allowed to claim a deduction for interest on any amount of education loan indebtedness for which a credit or deduction is allowed under any other provision.

Effective Date

The bill would be effective for taxable years beginning after December 31, 1993, and only for loans whose first payments are due after that date.

8. Defer gains from real property condemnations (H.R. 142)

Present Law

In general, gain or loss is recognized on any sale, exchange or other disposition of property. A taxpayer may, however, elect to defer gain for certain involuntary conversions (including condemnations) to the extent that the taxpayer reinvests the proceeds from the conversion into property that is similar or related in service or use to the property converted (sec. 1033).

Description of Proposal

The bill (H.R. 142) would provide for the deferral of gain on long-term real property that is involuntarily converted as the result of the exercise of eminent domain, if any other replacement property is acquired (without regard to whether the replacement property is similar or related in service or use to the property converted). Long-term real property means real property that is held by the taxpayer for at least 10 years at the time that the property was involuntarily converted.

Effective Date

The bill would be effective for dispositions of converted property occurring on or after October 1, 1991.

9. Deduction for State and local sewer and water fees

Present Law

Individuals may claim an itemized deduction for State or local real property taxes. Fees imposed for sewer and water services are not deductible as State or local real property taxes.

Description of Proposal

The proposal would permit individuals to claim an itemized deduction for fees imposed by a State or local government for sewer and water services to the extent the fees exceed one percent (or alternatively, two percent) of the taxpayer's adjusted gross income.

Effective Date

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

10. Extend certain tax benefits to soldiers serving in Somalia (H.R. 494)

Present Law

If the President issues an Executive Order declaring an area as a combat zone, members of the Armed Forces serving within that zone are eligible for certain tax benefits. The President has not declared Somalia to be a combat zone.

Description of Proposal

The bill (H.R. 494) would extend to members of the Armed Forces serving in the Somalia relief effort certain tax benefits in the Code that apply to service in a combat zone. The bill would require the President to designate an "Operation Restore Hope service area" and would treat all services in such area by a member of the Armed Forces as service in a combat zone as defined in Code section 112.

The proposal's treatment of services as having been provided in a combat zone would be for purposes of the following provisions:

(1) *Code section 112.*—Exclusion of pay from gross income for members of the Armed Forces for each month served in the Restore Hope area or hospitalized as a result of injury, wounds, or disease incurred while serving in such area. For commissioned officers, the exclusion would be limited to $500 per month.

(2) *Code section 692.*—Elimination of certain income tax liabilities of a member of the Armed Forces who dies while serving in the Restore Hope area or as a result of injury, wounds, or disease incurred while serving in such area. Tax liabilities would be forgiven for the year of death and any prior year ending on or after the date the member began service in the Restore Hope area. Uncollected taxes for any other prior years would be forgiven.

(3) *Code section 2201.*—Federal estate tax forgiveness for a U.S. citizen or resident who is a member of the Armed Forces and who dies under conditions enumerated in previous paragraph.

(4) *Code section 3401(a)(1).*—The exemption from income tax withholding.

(5) *Code section 7508.*—For many taxpayer rights and duties, the period of Restore Hope services (including any resulting hospitalization) plus the following 180 days would be disregarded when determining whether deadlines have been met. The duties postponed would include filing returns, claiming refunds, and paying taxes.

Effective Date

The bill would be effective for periods beginning on or after December 3, 1992.

11. Charitable deduction for non-itemizers (H.R. 152)

Present Law

In computing taxable income, individuals who do not elect the standard deduction may claim itemized deductions, including a deduction (subject to certain limitations) for charitable contributions or gifts made to a qualified charitable organization during the taxable year (sec. 170).[36] Individuals who elect the standard deduction may not claim a deduction for charitable contributions made during the taxable year.[37] Corporations are entitled to claim a deduction for charitable contributions, generally limited to 10 percent of their taxable income (computed without regard to the contribution).

In the case of an individual taxpayer, the total amount of otherwise allowable itemized deductions (other than medical expenses, casualty and theft losses, and investment interest) is reduced by three percent of the amount of the taxpayer's AGI in excess of $108,450 in 1993 (indexed for inflation). Under this present-law provision, otherwise allowable deductions are reduced by not more than 80 percent, and the reduction of otherwise allowable deductions does not apply to taxable years beginning after 1995.

Description of Proposal

Under the bill (H.R. 152), individuals who elect the standard deduction would be permitted to deduct charitable contributions (subject to the present-law rules that apply to charitable contributions made by individuals who itemize deductions).

Under the bill, the deduction for charitable contributions would be a "below-the-line" deduction (meaning that the deduction would not be taken into account in computing an individual's AGI). If an individual elects to itemize deductions, then charitable contributions must be included with other itemized deductions (and potentially would be subject to the cutback of itemized deductions applicable to certain high-income individuals).

Effective Date

The bill would be effective for contributions made after December 31, 1992.

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[36] In computing taxable income, a taxpayer who itemizes generally is allowed to deduct the fair market value of property contributed to a charity (subject to annual percentage limitations based on the individual's AGI, the type of property contributed, and the type of donee organization). However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property (sec. 170(e)). For purposes of computing alternative minimum taxable income (AMTI), the deduction for charitable contributions of capital gain property is disallowed to the extent that the fair market value of the property exceeds its adjusted basis (sec. 57(a)(6)).

[37] Prior to 1982 (as under present law), only itemizers were allowed a deduction for charitable contributions. This deduction was extended to non-itemizers during 1982-1986, subject to differing limitations during those years. The maximum charitable contribution deduction for non-itemizers was $25 in 1982 and 1983, and $75 for 1984. For 1985, 50 percent of the amount contributed was deductible (without a dollar cap) and, for 1986, 100 percent of the amount contributed was deductible (without a dollar cap).

12. Allow taxpayers receiving unemployment compensation to elect Federal income tax withholding

Present Law

Gross income includes payments of unemployment compensation. There is no Federal income tax withholding from payments of unemployment compensation.

Description of Proposal

The proposal would permit taxpayers who receive payments of unemployment compensation to elect Federal income tax withholding at a flat 15-percent rate.

Effective Date

The proposal would be effective for payments of unemployment compensation made after December 31, 1993.

H. Estate and Gift Tax Provisions

1. Treatment of retirement benefits under community property laws

Present Law

Community property

Under state community property laws, each spouse owns an undivided one-half interest in each community property asset. In community property jurisdictions, a nonparticipant spouse may be treated as having a vested community property interest in either his or her spouse's qualified plan, individual retirement arrangement (IRA), or simplified employee pension (SEP) plan.

Transfer tax treatment of qualified plans

In the Retirement Equity Act of 1984 (REA), qualified retirement plans were required to provide automatic survivor benefits (1) in the case of a participant who retires under the plan, in the form of a qualified joint and survivor annuity, and (2) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, in the form of a preretirement survivor annuity. A participant is generally permitted to waive such annuities, provided he or she obtains the written consent of his or her spouse.

The Tax Reform Act of 1986 repealed the estate tax exclusion, formerly contained in sections 2039(c) and 2039(d), for certain interests in qualified plans owned by a nonparticipant spouse attributable to community property laws and made certain other changes to conform the transfer tax treatment of qualified and nonqualified plans.

As a result of these changes made by REA and the Tax Reform Act of 1986, the transfer tax treatment of married couples residing in a community property state is unclear where either spouse is covered by a qualified plan.

Description of Proposal

The proposal would clarify the transfer tax treatment of married residents of community property states where either spouse is covered by an IRA, SEP, or qualified pension plan (collectively hereinafter referred to as a "plan"). First, the proposal would clarify that the marital deduction is available with respect to a nonparticipant spouse's interest in a plan attributable to community property laws where he or she predeceases the participant spouse. Under the proposal, the nonparticipant spouse's interest is deemed to pass to the surviving participant spouse in a manner that qualifies for treatment as qualified terminable interest property (QTIP) under section 2056(b)(7),[38] unless the will of the nonparticipant spouse ex-

[38] In general, QTIP is property which passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and which the executor elected to treat as QTIP. A surviving spouse generally has a qualifying income interest for life if he or she is entitled to all the income from the property payable at least annually, and no person has the power to appoint any part of the property to any person other than the surviving spouse.

pressly provides otherwise. A conforming amendment is made to section 2044.

Second, the refusal by a nonparticipant spouse to accept an interest in a plan would constitute a qualified disclaimer under the proposal, provided that the requirements for a qualified disclaimer are satisfied under section 2518.[39]

Third, the proposal provides that the following events would not constitute a transfer for Federal transfer tax purposes: (1) acquisition of a survivor benefit by a nonparticipant spouse; (2) waiver by a participant spouse of a survivor benefit or any right thereto prior to his or her death; and (3) consent by a nonparticipant spouse to a participant spouse's waiver of a survivor benefit or any right thereto.

Finally, with respect to plans not subject to REA's spousal annuity provisions, the proposal would clarify that a nonparticipant spouse will not be deemed to have made a taxable transfer at the participant spouse's death where the participant spouse disposes of the community property interest of the nonparticipant spouse in the plan to someone other than that spouse.

Effective Date

The proposal would apply to decedents dying, or waivers, transfers and disclaimers made, after the date of enactment.

2. Treatment of land subject to permanent conservation easement (H.R. 2031)

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, *i.e.*, the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.

[39] The requirements for a qualified disclaimer generally are: (1) the disclaimer must be an irrevocable and unqualified written refusal to accept the ownership of an interest in property; (2) the disclaimer must be received by the later of nine months of the date of transfer, or nine months of the disclaiming person's 21st birthday; (3) the disclaimant must not have accepted the interest in property or any of its benefits; and (4) as a result of the disclaimer, the property must pass, without any direction by the disclaimant, to the decedent's spouse or to a person other than the disclaimant (sec. 2518(b)).

Description of Proposal

Qualification for exclusion

The bill (H.R. 2031) would provide that an executor may elect to exclude from the estate and gift tax the value of any land subject to a qualified conservation easement (less the amount of any indebtedness to which the land is subject). To qualify under the bill, the land (1) must be located within 50 miles of a metropolitan area (as defined by the Office of Management and Budget) or a National Park or a wilderness area (in which case land within 50 miles of such National Park or wilderness area[40] must also be under significant development pressure, as determined by the Treasury Department), (2) must have been owned by the transferor or a member of his or her family within three years of his or her death or the date of gift (as applicable), and (3) a qualified conservation contribution (within the meaning of section 170(h)) of a qualified real property interest (as generally defined in section 170(h)(2)(C)) has been granted by the transferor or a member of his or her family. The basis of such land acquired at death would be a carryover basis (i.e., the basis would not be stepped-up to its fair market value at death). Land would not qualify under the proposal if it is located within an historically important land area (as defined under section 170(h)(4)(A)(iv)) or it includes a certified historic structure (as defined under section 170(h)(4)(B)). For this purpose, a member of the decedent's family includes his or her ancestors, his or her spouse, a lineal descendant of the decedent, the decedent's spouse or the decedent's parents, and the spouse of any of the foregoing lineal descendants (sec. 2032A(e)(2)).

Retained development rights

The exclusion would not extend to the value of any development rights retained by the decedent or donor. The estate or gift tax on the retained development rights would only be imposed upon the disposition (other than by gift or devise), either in whole or in part, of the property. Such tax would be due (without interest) on April 15th of the calendar year following the year of disposition. For this purpose, retained development rights are retained rights to establish or use any structure (and the land immediately surrounding it) for sale, rent or any other commercial purpose, which is not subordinate to and directly supportive of (1) the conservation purpose identified in the easement, or (2) the activity of farming, forestry, ranching, horticulture, viticulture, or recreation, whether or not for profit, conducted on the land subject to the easement.

An executor would be required to compute the amount of the deferred estate tax on any retained development right and to include such amount on the estate tax return. The executor would also be required to file a notice regarding the deferred estate tax with the land records for the locality in which the land is located.

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[40] For this purpose, a wilderness area means an area designated as such under The Wilderness Act (P.L. 88-577).

Effective Date

The bill would apply generally to qualified conservation easements granted after December 31, 1992.

3. Estate tax valuation of family-owned media businesses

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. In certain instances, however, the Code provides alternative methods of valuation. For example, an executor may elect to value certain qualified real property used in farming or another qualifying trade or business at its current use value rather than its highest and best use (sec. 2032A).

Description of Proposal

Determination of value

The proposal would provide a statutory formula for determining the value of a decedent's interest in a qualifying family-owned and controlled media business for Federal estate tax purposes. Under the proposal, the value of a qualifying business would equal the net cash flow from the business for the fiscal year immediately preceding the decedent's date of death, multiplied by seven. The net cash flow would be determined from the financial statements of the business for that fiscal year,[41] which must be prepared in accordance with generally accepted accounting principles, consistently applied.

Qualification

To qualify for use of the statutory formula under the proposal, several requirements must be satisfied. First, the decedent must be a United States citizen or resident at the time of his or her death. Second, the decedent's interest in the business must exceed 35 percent of the value of the adjusted gross estate (i.e., the gross estate, including the value of the media business as determined under the proposal, reduced by any deductions allowable under sections 2053 and 2054). In certain instances, the proposal permits two or more family-owned and controlled media businesses to be aggregated for purposes of applying the 35-percent test.

Third, the business must have been actively engaged in media activities throughout the ten-year period ending on the date of the decedent's death. Media activities include, for this purpose, radio and television broadcasting (including air and satellite transmission), related satellite services, television and radio production and broadcast transmission facilities, and similar media activities.

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[41] With respect to a holding company that qualifies as a family-owned and controlled media business under the proposal, the consolidated financial statements of the holding company would be used.

Fourth, the company must have been owned and controlled by the decedent and/or members of his or her family throughout such ten-year period. For this purpose, owned and controlled means (1) ownership of a proprietorship, (2) at least 20 percent ownership of the total capital in a partnership, or (3) at least 20 percent ownership of the total combined voting power of a corporation and 20 percent ownership of all other classes of stock in such corporation. A member of the decedent's family includes his or her ancestors, his or her spouse, a lineal descendant of the decedent, the decedent's spouse or the decedent's parents, and the spouse of any of the foregoing lineal descendants.

Finally, at the time of the decedent's death, the ownership interests of the company may not be publicly traded.

Treatment of holding companies

A holding company may qualify for use of the statutory formula if (1) at least two thirds of the value of its and all of its subsidiary businesses' assets are used, directly or indirectly, in carrying on media activities, and (2) the other requirements for qualification under the proposal are met. For this purpose, a subsidiary business is any business in which the holding company owns stock or any other ownership interest.

Effective Date

The proposal would apply to estates of decedents whose Federal estate tax returns are due on or after January 1, 1993. However, with respect to decedents whose federal estate tax returns are due on or after January 1, 1995, the value determined by the statutory formula under the proposal would only constitute a rebuttable presumption.

4. Increase maximum reduction under special use valuation election (H.R. 1411)

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

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

Description of Proposal

The bill (H.R. 1411) would increase the maximum reduction in the value of qualified property resulting from an election under section 2032A to $1,500,000.

Effective Date

The bill would apply to decedents dying after the date of enactment.

5. Tax treatment of certain disclaimers

Present Law

A disclaimer is an irrevocable and unqualified refusal to accept an interest in property. If a disclaimer is qualified for Federal tax purposes, the Federal estate, gift, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to the disclaimer will not be treated as a taxable gift.

Under present law (applicable to transfers occurring after December 31, 1976), a disclaimer is effective for Federal transfer tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and certain other requirements are satisfied (sec. 2518). One of these other requirements is that the disclaimer generally must be made in writing not later than nine months after the transfer creating the interest occurs.

Prior to the enactment of section 2518, however, no uniform Federal law existed regulating the manner or timing of disclaimers. Before the promulgation of regulations in 1958, the administrative practice of the Internal Revenue Service was to allow the Federal tax consequences of a disclaimer to depend upon its treatment under local law.

On November 14, 1958, Treasury regulations were issued stating that, in order for a disclaimer to be effective for estate and gift tax purposes, the disclaimer had to be effective under local law and that it had to be made "within a reasonable time after knowledge of the existence of the transfer." It was not clear even after promulgation of this regulation, however, whether an individual wishing to disclaim a remainder interest was required to do so within a reasonable time after he or she obtained knowledge of the creation of the remainder interest or a reasonable time after the interest vested, or became possessory. *Compare Keinath v. Commissioner*, 58 T.C. 352 (1972) with *Keinath v. Commissioner*, 480 F.2d 57 (1973) (the Eighth Circuit overruled the Tax Court and upheld the taxpayer's position that a disclaimer of a future interest was timely when made within a reasonable time after termination of the prior interest).

This issue was finally resolved by the Supreme Court in *Jewett v. Commissioner*, 102 S. Ct. 1082 (1982), which held that the correct interpretation of the 1958 regulation required an individual wishing to disclaim an interest created prior to November 15, 1958 to disclaim the remainder interest within a reasonable time after the original transfer creating the remainder interest occurred. Thus, for example, where property was transferred in 1939 to X for life, with the remainder to Y, Y was required to disclaim his or her interest within a reasonable time of the original transfer, even though the original transfer occurred long before the 1958 regulation was issued and Y could not take possession until X's death.

Description of Proposal

Under the proposal, a disclaimer with respect to an interest created by a transfer prior to November 15, 1958 would not be treated as a transfer for estate and gift tax purposes and would be deemed to satisfy the requirements of Treasury regulation section 25.2511-1(c) (as in effect at the time the disclaimer was made) if the disclaimer was made (1) in writing before May 22, 1972,[42] and (2) no later than a reasonable time after the interest vests or becomes possessory.

Effective Date

The proposal would be effective for claims for refund made within one year of the date of enactment. The proposal would apply to such claims for refund regardless of any statute of limitations, any law regarding final court (or other) determinations, and any law barring multiple suits on one cause of action.

6. Estate tax recapture from cash leases of specially valued property

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

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

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

Description of Proposal

The proposal would provide that the cash lease of specially valued real property by a qualified heir to a "member of the family" (as defined in section 2032A(e)(1)) of the decedent, who continues

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[42] This is the date of the U.S. Tax Court's decision in *Keinath v. Commissioner*, which upheld the IRS's position that the 1958 regulations required a disclaimer of a contingent interest to be made within a reasonable time after creation of the interest, rather than its vesting or becoming possessory.

to operate the farm or closely held business, does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

Effective Date

The proposal would be effective for cash rentals after December 31, 1976.

7. Estate tax marital credit for certain employees of international organizations (H.R. 770).

Present Law

Property subject to tax

A Federal estate tax is imposed on the value of property passing at death. If a decedent was a United States citizen or resident, the estate tax is determined by reference to all of his or her property, wherever situated. In contrast, if a decedent was a nonresident alien, the estate tax is determined only by reference to the decedent's property situated in the United States.

Treasury regulations provide that a "resident" decedent is one who was domiciled in the United States at the time of his or her death and that residence without an intention to remain indefinitely does not establish domicile (Treas. Reg. sec. 20.0-1(b)). Thus, whether a decedent employed in the United States by an international organization is domiciled in the United States depends upon whether the decedent intended to remain in the United States indefinitely. *See* Rev. Rul. 80-363, 1980-2 C.B. 250.

Marital deduction

To determine the taxable estate of a decedent, a deduction is generally allowed for the value of any property which passes to a citizen spouse, but not for the value of property passing to a noncitizen spouse. Property passing to a noncitizen spouse, however, may qualify for the marital deduction if it passes (or is treated under section 2056(d)(2)(B) as passing) to a qualified domestic trust or the surviving spouse becomes a United States citizen before the estate tax return is filed (sec. 2056(d)).

Description of Proposal

The bill (H.R. 770) would provide a credit against the tax on property passing to a noncitizen spouse if either the decedent or the spouse is employed full-time by an international organization and has a principal place of employment with such organization in the United States.[43] The credit would be available only if, at the date of the decedent's death, neither spouse is a United States citizen or lawful permanent resident of the United States (i.e., a green card holder), and the executor of the estate waives the right to use a qualified domestic trust under section 2056A.

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[43] The term "international organization" is defined under section 7701(a)(18) as a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act (22 U.S.C. 288-288f).

The credit available under the bill would depend upon whether the decedent, on the date of death, is a United States resident for Federal estate tax purposes. In the case of the estate of a resident decedent, the applicable marital transfer credit would equal the excess of (1) the estate tax on the sum of the marital transfer amount and the greater of (a) the decedent's adjusted taxable gifts or (b) $600,000, over (2) the estate tax on the greater of (a) the decedent's adjusted taxable gifts or (b) $600,000. The marital transfer amount is the amount that would have qualified for the marital deduction if the spouse were a United States citizen, but cannot exceed either $600,000, or the excess of the sum of the taxable estate and the adjusted taxable gifts over $600,000. Thus, the marital transfer credit allowed the estate of a resident decedent would effectively equal an exemption of $600,000, in addition to the amount exempted by the unified credit.

In the case of the estate of a nonresident decedent, the applicable marital transfer credit would equal the excess of (1) the estate tax on the sum of the marital transfer amount and the greater of (a) the decedent's adjusted taxable gifts or (b) the deduction equivalent of the unified credit, over (2) the estate tax on the greater of (a) the decedent's adjusted taxable gifts or (b) the deduction equivalent of the unified credit. For this purpose, the marital transfer amount cannot exceed either (1) $600,000, reduced by the deduction equivalent of the unified credit, or (2) the excess of the sum of the taxable estate and the adjusted taxable gifts over the deduction equivalent of the unified credit. The deduction equivalent of the unified credit is the amount of property the tax on which would equal the unified credit allowed by the Code or by treaty. Thus, the marital transfer credit allowed the estate of a nonresident decedent effectively would be equal to $600,000, reduced by the amount exempted by the unified credit.

Effective Date

The bill would apply to decedents dying after the date of enactment.

I. Foreign Tax Provisions

1. Treatment of foreign base company sales and services income of controlled foreign corporations in the European Community (H.R. 1401)

Present Law

U.S. persons generally are taxed currently by the United States on their worldwide income. U.S. tax on foreign source income may be reduced by credits for foreign income taxes paid by the U.S. person. Foreign income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment of a dividend to its U.S. stockholders.

Under the rules of subpart F, certain types of income of U.S.-controlled foreign corporations are included currently in the income of 10-percent U.S. shareholders and taxed by the United States, regardless of whether the income is actually distributed currently to the shareholders. Types of income deemed distributed (generally referred to as "subpart F income") include foreign base company sales income, foreign base company services income, foreign base company shipping income, foreign base company oil related income, and foreign personal holding company income (collectively referred to as foreign base company income), and certain insurance income.

Foreign base company sales income consists of income attributable to related party purchases and sales if the income recipient's country is neither the origin nor the destination of the goods. Foreign base company services income consists of income from services performed outside the country of the corporation's incorporation, for or on behalf of related persons.

Description of Proposal

The bill (H.R. 1401) would allow certain European countries to be treated as a single country for purposes of the subpart F rules pertaining to foreign base company sales income and foreign base company services income.

The bill would apply to countries that are members of the Council of Ministers of the European Communities (Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom), but only if they satisfy two conditions. First, the country must have a maximum statutory tax rate greater than 90 percent of the maximum U.S. corporate income tax rate. Second, the country must not apply preferential taxation to foreign base company sales and services income of the controlled foreign corporation, whether by an exemption pursuant to a tax holiday, a preferential statutory rate, or a similar special rule.

Effective Date

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

2. Pass-through treatment for certain dividends paid by a regulated investment company to foreign persons (H.R. 1891)

Present Law

Regulated investment companies

A regulated investment company ("RIC") is a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)).

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). These tests include a requirement that the corporation derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investment in such stock, securities, or currencies.

Generally, a RIC pays no income tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. The amount of any distribution generally is not considered as a dividend for purposes of computing the dividends paid deduction unless the distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class (sec. 562(c)). For distributions by RICs to shareholders who made initial investments of at least $10,000,000, however, the distribution is not treated as non-pro rata or preferential solely by reason of an increase in the distribution due to reductions in administrative expenses of the company.

A RIC generally may pass through to its shareholders the character of its long-term capital gains. It does this by designating a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain (i.e., net long-term capital gain over net short-term capital loss). These capital gain dividends are treated as long-term capital gain by the shareholders. A RIC generally also can pass through to its shareholders the character of tax-exempt interest from State and municipal bonds, but only if, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations. In this case, the RIC generally may designate a dividend it pays as an exempt-interest dividend to the extent that the RIC has tax-exempt interest income. These exempt-interest dividends are treated as interest excludable from gross income by the shareholders.

The Internal Revenue Service has stated its position that if a RIC has two or more classes of stock and it designates the dividends that it pays on one class as consisting of more than that class's proportionate share of a particular type of income, the designations are not effective for Federal tax purposes to the extent that they exceed the class's proportionate share of that type of income (Rev. Rul. 89-81, 1989-1 C.B. 226). Thus, in order to achieve all the tax effects provided under the Code for such RIC dividends, a capital gain dividend or an exempt-interest dividend must be pro rata within a class of RIC stock, and, with respect to any one class of RIC stock, generally cannot (under the Service's interpretation of present law) exceed that proportion of the relevant capital gain or exempt interest income of the RIC that the amount of dividends paid to shareholders of that class of stock bears to the total amount of dividends paid by the RIC.

U.S. source investment income of foreign persons

Under the Code, the United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S. source investment income payments, such as interest and dividends, to nonresident alien individuals and foreign corporations ("foreign persons") (secs. 871(a), 881, 1441, and 1442). Under treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, however, the tax on a dividend generally is not entirely eliminated. Instead, U.S. source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

Interest

There is no 30-percent gross-basis U.S. tax with respect to U.S. source bank deposit interest that is not effectively connected with the conduct of a trade or business within the United States. Nor is there such a tax on the amount includible in gross income as original issue discount on an obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer).

Nor is there 30-percent gross-basis U.S. tax on so-called "portfolio interest." Portfolio interest includes interest (including original issue discount) which would be subject to the gross-basis U.S. tax but for the fact that certain requirements are met with respect to the obligation on which the interest is paid, and with respect to the interest recipient (or the location of the interest recipient). Pursuant to these requirements, the obligation must be in registered form or be "foreign-targeted." The U.S. person who otherwise would be required to withhold tax must receive a statement that the beneficial owner of the obligation is not a United States person. If the obligation was issued by a corporation or a partnership, the recipient of the interest must not be a "10-percent shareholder" of the corporation or partnership. A corporate recipient of the interest must be neither a controlled foreign corporation receiving interest from a related person, nor (unless the obligor is the United States) a bank receiving the interest on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business. The payment of interest must not be to any person within a foreign country (and must not be a payment addressed to, or for the account of, persons within a foreign country) with respect to which the Treasury Secretary has determined that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons. This last requirement does not currently affect the exemption from tax on interest, as no such determinations have been made to date.

Capital gains

Under the Code, foreign persons generally are not subject to U.S. tax on gain realized on the disposition of stock or securities issued by a U.S. person (other than a "U.S. real property holding corporation," as described below), unless the gain is effectively connected with the conduct of a trade or business in the United States. This exemption does not apply, however, to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year. Foreign persons receiving capital gain dividends from U.S. RICs have been treated as receiving capital gains not subject to U.S. tax, rather than dividends subject to the ordinary U.S. withholding tax on dividends (see Rev. Rul. 69-244, 1969-1 C.B. 215).

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), as amended, gain or loss of a foreign person from the disposition of a U.S. real property interest is subject to net basis tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business. In addition to fee ownership of U.S. real property, U.S. real property interests include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a 5-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which is defined generally to mean a corporation the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).

Under FIRPTA, a distribution by a real estate investment trust ("REIT") to a foreign person is, to the extent attributable to gain from sales or exchanges by the REIT of U.S. real property interests, treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. Under Treasury regulations, a REIT is generally required to withhold tax upon such a distribution to a foreign person, at a rate of 34 percent times the maximum amount of that distribution that could be designated by the REIT as a capital gain dividend (Treas. Reg. sec. 1.1445-8(a)(2), (b)(1), and (c)(2)).

In view of the nature of a REIT, an interest in a REIT may in some cases be considered to be a U.S. real property interest. However, an interest in a domestically-controlled REIT is not considered a U.S. real property interest. Also, the foreign ownership percent of taxable appreciation in the value of a U.S. real property interest held by a domestically-controlled REIT is subject to tax in the hands of the REIT under special FIRPTA rules upon distribution of the U.S. real property interest by the REIT.

Estate taxation

For U.S. citizens and residents, the amount subject to Federal estate tax generally is determined by reference to all the decedent's property, wherever situated. For nonresident noncitizens, the amount subject to that tax under the Code generally is determined only by reference to the decedent's property situated in the United

States.[44] Property situated in the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident noncitizen is treated as property situated in the United States if and only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

Treaties may reduce U.S. taxation on transfers by estates of foreign decedents. Under newer treaties, for example, U.S. tax may generally be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Description of Proposal

In general

Under the bill (H.R. 1891), a RIC that earns certain interest income which would not be subject to U.S. tax if earned by a foreign person generally may, to the extent of such income, designate a dividend it pays as deriving from such interest income. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had earned the interest directly. Similarly, a RIC that earns an excess of net short-term capital gains over net long-term capital losses, which excess would not be subject to U.S. tax if earned by a foreign person, generally may, to the extent of such excess, designate a dividend it pays as deriving from such excess. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had realized the excess directly. The estate of a foreign decedent would be exempt from U.S. estate tax on a transfer of stock in the RIC in proportion that the assets held by the RIC are debt obligations, deposits, or other property that would generally be treated as situated outside the United States if held directly by the estate.

Interest-related dividends

Under the bill, a RIC could, under certain circumstances, designate all or a portion of a dividend as an "interest-related dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. An interest-related dividend received by a foreign person generally would generally be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442.

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[44] The term "nonresident noncitizen" is defined differently than the term "nonresident alien," which is used above in connection with the explanation of the income tax rules. For estate tax purposes, Treasury regulations provide that a "resident" decedent is one who was domiciled in the United States at the time of his or her death, and that residence without an intention to remain indefinitely does not establish domicile (Treas. Reg. sec. 20-1(b)). By contrast, a person may be a "resident" for income tax purposes by virtue of residence without regard to his or her intention. Therefore, it would be possible for a person to be a resident for income tax purposes and a nonresident for estate tax purposes.

This exemption would not apply, however, to a dividend on shares of RIC stock in a case where the withholding agent does not receive a statement, similar to that required under the portfolio interest rules, that the beneficial owner of the shares is not a U.S. person. The exemption would not apply to a dividend paid to any person within a foreign country (or dividends addressed to, or for the account of, persons within such foreign country) with respect to which the Treasury Secretary has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons.

In addition, the exemption generally would not apply to dividends paid to a controlled foreign corporation to the extent such dividends are attributable to income received by the RIC on a debt obligation of a person with respect to which the recipient of the dividend is a related person. Nor would the exemption generally apply to dividends to the extent such dividends are attributable to income (other than short-term original discount or bank deposit interest) received by the RIC on indebtedness issued by any corporation or partnership with respect to which the recipient of the dividend is a 10-percent shareholder with respect to any entity the obligations of which are held by the RIC. In these two cases, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient is such a controlled foreign corporation or 10-percent shareholder. To the extent that an interest-related dividend received by a controlled foreign corporation is attributable to interest income of the RIC that would be portfolio interest if received by a foreign corporation, the dividend would be treated as portfolio interest for purposes of the de minimis rules, the high-tax exception, and the same country rules of subpart F (see sec. 881(c)(4)).

The aggregate amount designated as interest-related dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the qualified net interest income of the RIC for the taxable year. The qualified net interest income of the RIC equals the excess of (a) the amount of qualified interest income of the RIC over (b) the amount of expenses of the RIC properly allocable to such interest income.

Qualified interest income of the RIC is the sum of bank deposit interest, short term original issue discount that is currently exempt from the gross-basis tax under section 871, and any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of Code sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder.

Where the amount designated as an interest-related dividend is greater than the qualified net interest income described above, then the portion of the distribution so designated which constitutes an interest-related dividend will be only that proportion of the amount so designated as the amount of the qualified net interest income bears to the amount so designated.

Taxable interest dividends

Under the bill, a RIC could also designate all or a portion of a dividend as a "taxable-interest dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. A taxable-interest dividend would be treated by the recipient shareholder as interest for all purposes of the income tax provisions of the Code. The aggregate amount designated as taxable-interest dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the net taxable interest income of the RIC for the taxable year. The net taxable interest income of the RIC equals the excess of (a) the amount of interest income of the RIC for the year other than amounts excludable from gross income under section 103(a)) over (b) the amount of expenses of the RIC properly allocable to such interest income.

Interest income of the RIC includes amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of Code sections 1271-1288, and such other amounts as regulations may provide.

Where the amount designated as a taxable-interest dividend is greater than the net taxable interest income described above, then the portion of the distribution so designated which constitutes a taxable-interest dividend will be only that proportion of the amount so designated as the amount of the net taxable interest income bears to the amount so designated.

Short term capital gain dividends

Under the bill, a RIC could also, under certain circumstances, designate all or a portion of a dividend as a "short term capital gain dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. For purposes of the U.S. gross-basis tax, a short term capital gain dividend received by a foreign person generally would be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442. This exemption would not apply to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year. In this case, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient has been present in the United States for such period.

The aggregate amount designated as short term capital gain dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) is the excess of the RIC's net short-term capital gains over net long-term capital losses. As is provided under present law for purposes of computing the amount of a capital gain dividend, the amount is determined (except in the case where an election under section 4982(e)(4) applies) without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the year. Instead, that loss would be treated as arising on the first day of the next taxable year. To the extent provided in regulations, this rule would apply also for purposes of computing the taxable income of the RIC.

In computing the amount of short term gain capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC allocable to such net gains. For example, assume that the RIC has net income of $100 before paying dividends, comprised of dividend income of $60, short-term capital gains of $60, and expenses of $20. Shareholders of the RIC receive dividends of $100. Under the bill, the expenses are effectively allocated solely to the RIC's dividend income, with the result that only 40 percent of the foreign RIC shareholders' dividend income may be subject to U.S. withholding tax under the bill, even though 50 percent of the RIC's gross income is income that would be subject to U.S. withholding tax if earned directly by the shareholder.

Where the amount designated as short term capital gain dividends is greater than the amount as defined above, then the portion of the distribution so designated which constitutes a short term capital gain dividend will be only that proportion of the amount so designated as the amount of the excess bears to the amount so designated.

As is true under current law for distributions from REITs, the bill provides that any distribution by a RIC to a foreign person shall, to the extent attributable to gains from sales or exchanges by the RIC of an asset (for example, stock) that is considered a U.S. real property interest, be treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. The bill also extends the special rules for domestically-controlled REITs to domestically-controlled RICs.

Estate tax treatment

Under the bill, a portion of the stock in a RIC held by the estate of a nonresident noncitizen decedent would be treated as property situated outside the United States. The portion so treated would be based on the proportion of the assets held by the RIC at the end of the quarter immediately preceding the decedent's death (or such other time as the Secretary may designate in regulations) that are "qualifying assets." Qualifying assets for this purpose are bank deposits of the type that are exempt from gross-basis income tax, portfolio debt obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the United States.

Effective Date

The bill would be effective with respect to taxable years of RICs beginning after date of enactment.

3. Treatment of software licensing income earned by a foreign sales corporation

Present Law

A portion of the export income of an eligible foreign sales corporation (FSC) is exempt from Federal income tax. If the income earned by the FSC is determined under special administrative pricing rules, then the exempt foreign trade income generally is 15/23 of the foreign trade income the FSC derives from the transaction. In addition, a domestic corporation is allowed a 100-percent deduction for dividends received from the FSC out of earnings attributable to certain foreign trade income. Thus, there generally is no corporate level tax imposed on a portion of the income from exports of a FSC.

Typically, a FSC is a company owned by a U.S. company, such as a manufacturer, that produces goods in the United States. The U.S. company either supplies the goods to the FSC for resale abroad to unrelated persons, or pays the FSC a commission in connection with its own sales to unrelated persons. Therefore, the income of the FSC, a portion of which is exempt under the FSC rules, equals the FSC's gross markup or gross commission income, less the expenses incurred by the FSC itself. A FSC must have a foreign presence, it must have economic substance, and activities that relate to its export income must be performed by the FSC outside the U.S. customs territory.

Foreign trade income is defined as the gross income of a FSC attributable to foreign trading gross receipts. Foreign trade income includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products or services exported by others. In general, the term foreign trading gross receipts means the gross receipts of a FSC which are attributable to the export of certain goods and services. Foreign trading gross receipts are the gross receipts of a FSC that are attributable to the following types of transactions: the sale of export property, the lease or rental of export property, services related and subsidiary to the sale or lease of export property, engineering and architectural services, and export management services.

Export property, for purposes of the FSC rules, is defined as property that is (1) manufactured, produced, grown, or extracted in the United States by a person other than a FSC, (2) held primarily for sale, lease, or rental, in the ordinary conduct of a trade or business by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. Specifically excluded from the definition of export property, however, are copyrights other than films, tapes, records, or similar reproductions, for commercial or home use (Code sec. 927(a)(2)(B)). Treasury regulations promulgated under this provision provide specifically that copyrights on books or computer software do not constitute export property (Treas. Reg. sec. 1.927(a)-1T(f)(3)).

Description of Proposal

The proposal would provide that export property for purposes of the FSC rules includes the license of computer software to foreign distributors and customers with the right to reproduce.

Effective Date

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

4. Expand foreign sales corporation tax exemption for military property

Present Law

As described above in Item I.3., a portion of the income of an eligible foreign sales corporation (FSC) which is attributable to export property is exempt from Federal income tax.

The FSC rules contain a special limitation relating to the export of military property (sec. 923(a)(5)). Under regulations prescribed by the Treasury Secretary, that portion of a FSC's foreign trading gross receipts for the taxable year attributable to the disposition of, or services relating to, military property which may be treated as exempt foreign trade income shall equal 50 percent of the amount which otherwise would be treated as exempt foreign trade income (Treas. Reg. sec. 1.923-1T(b)(3)). Thus, taxpayers who export military property through FSCs are allowed only one-half of the tax benefit which exporters of non-military property are permitted.

For this purpose, the term "military property" means any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2778) (which repealed the Military Security Act of 1954).

Description of Proposal

The proposal would repeal the special FSC limitation relating to the export of military property, thus providing military sales through a FSC the same treatment currently provided commercial sales.

Effective Date

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

5. Treatment of U.S. bank deposit interest received by certain Netherlands Antilles subsidiaries

Present Law

Under the U.S.-Netherlands tax treaty, as extended to the Netherlands Antilles by protocol (the "protocol"), certain interest paid by a resident of the United States to a resident of the Netherlands Antilles is exempt from U.S. withholding tax. Rules imposed under the Deficit Reduction Act of 1984 have the practical effect of limiting the continued application of the protocol so that it applies only to interest paid to certain Netherlands Antilles residents with respect to certain obligations that were issued prior to June 22, 1984. The protocol was terminated by the United States in 1987, but remains in partial effect for interest paid to certain residents of the Netherlands Antilles that continue to qualify under the requirements of the protocol and the Deficit Reduction Act of 1984.

By its terms, the protocol does not provide an exemption from U.S. withholding tax in the case of U.S.-source income derived by Netherlands Antilles residents that were eligible for certain "special tax benefits" in the Netherlands Antilles (Art. I(1) of the protocol of October 23, 1963). However, the withholding tax exemption is available to a Netherlands Antilles resident that elects to be taxed on all of its U.S.-source income under the standard Netherlands Antilles profits tax, foregoing the special tax benefits with respect to its U.S.-source income (Rev. Rul. 65-16, 1965-1 C.B. 626).

Prior to the Tax Reform Act of 1986, interest income of a foreign corporation from deposits in U.S. banks was treated as foreign source income. Under present law, however, such interest is treated as U.S. source income. Thus, since 1987, any interest income of a Netherlands Antilles corporation from deposits in U.S. banks is required to be subject to the standard Netherlands Antilles profits tax in order for that corporation to continue to qualify for the beneficial treatment of interest received with respect to pre-1984 obligations under the protocol.

Description of Proposal

The proposal would treat interest income earned by Netherlands Antilles subsidiaries of U.S. corporations from deposits in U.S. banks as foreign source income, solely for purposes of determining whether the Netherlands Antilles corporation qualifies for continued application of the U.S.-Netherlands tax treaty as extended to the Netherlands Antilles.

Effective Date

The proposal would be effective as if included in the Tax Reform Act of 1986. Accordingly, the proposal would apply to taxable years beginning after December 31, 1987.

6. Carryforward of certain pre-1987 foreign base company shipping losses

Present Law

As described above in Item I.1, when a U.S.-controlled foreign corporation earns so-called "subpart F income," the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their respective pro-rata shares of that income. One category of income that is considered subpart F income is "foreign base company shipping income."

The amount of subpart F income of a controlled foreign corporation that is included in the income of the foreign corporation's U.S. shareholders for any year is limited by the earnings and profits of the foreign corporation for that year. Moreover, if a controlled foreign corporation incurs a deficit in earnings and profits for a taxable year, then under certain circumstances that deficit can reduce future U.S. shareholder taxation that would otherwise occur under subpart F. To the extent that the deficit is attributable to certain qualified activities of the foreign corporation giving rise to subpart F income in a later year, the amount of the later-year subpart F income generated by that qualified activity and included in the income of the foreign corporation's U.S. shareholders is generally reduced.

The rules of subpart F were originally enacted in the Revenue Act of 1962, generally effective for taxable years of foreign corporations beginning after 1962. Rules treating foreign base company shipping income as subpart F income were enacted in the Tax Reduction Act of 1975, generally effective for taxable years of foreign corporations beginning after 1975. Rules treating foreign base company oil related income as subpart F income were enacted in the Tax Equity and Fiscal Responsibility Act of 1982, generally effective for taxable years of foreign corporations beginning after 1982.

The Tax Reform Act of 1986 ("1986 Act") substantially increased the effective subpart F taxation of foreign base company shipping income, subpart F insurance income, and foreign personal holding company income. Moreover, the 1986 Act, as amended by the Technical and Miscellaneous Revenue Act of 1988, substantially restricted the availability of prior year deficits to reduce current year subpart F inclusions.

Under pre-1986 Act law, foreign base company shipping income that was reinvested by a controlled foreign corporation in foreign shipping operations was excluded from foreign base company income (former sec. 954(b)(2)). (By the same token, a U.S. shareholder was (and still is) subject to a subpart F income inclusion upon withdrawal of the controlled foreign corporation's previously excluded subpart F income from foreign base company shipping operations.) The 1986 Act, which for this purpose generally applies only to taxable years beginning after 1986, repealed the reinvestment exception to subpart F taxation.

Also under pre-1986 Act law, subpart F inclusions of U.S. shareholders were reduced by deficits for prior years beginning after 1962 without regard to the type of activities generating the deficit or the type of controlled foreign corporation income for which the U.S. shareholder income inclusion was reduced (former sec. 952(c)). Currently, if a qualified activity gives rise to foreign base company sales or services income, deficits from that activity for years beginning after 1962 may be used to reduce only those subpart F inclusions attributable to foreign base company sales or services income, as the case may be. If the qualified activity gives rise to foreign base company oil related income, deficits from that activity for years beginning after 1982 may be used to reduce subpart F inclusions, and only those subpart F inclusions attributable to foreign base company oil related income may be so reduced. In these cases, then, deficits may be carried forward so long as they were generated in a year for which income from the activity was subpart F income subject to current inclusion under the then-current provisions of the Code.

If on the other hand the qualified activity gives rise to foreign base company shipping income, foreign personal holding company income of a qualified insurance company or a qualified financial institution, or subpart F insurance income of a qualified insurance company, only deficits for years beginning after 1986 may be used to reduce subpart F inclusions (again, only those subpart F inclusions attributable to activities giving rise to the deficits may be reduced by those deficits). In these cases, then, deficits may be carried forward only if they were generated in a year for which income from the activity was subpart F income subject to current inclusion under the rules as expanded by the 1986 Act.

Description of Proposal

If a qualified activity of a controlled foreign corporation gives rise to foreign base company shipping income, then under certain circumstances deficits attributable to such an activity for years beginning after 1975 and before 1987 would be permitted to be used to reduce subpart F inclusions of income from that activity. Pre-1987 deficits would be available if substantially all of the total of the amounts of foreign base company shipping income of the controlled foreign corporation for each of its taxable years beginning after 1975 and before 1987 (counting only those years, if any, for which those amounts were positive) either was currently included in the corporation's foreign base company income (without reduction under the reinvestment rule) or was included in the gross income of the corporation's U.S. shareholder or shareholders in a taxable year beginning before 1987. In addition, deficits permitted to be carried forward and used under this rule would be reduced by any amount excluded from the controlled foreign corporation's subpart F income (and not subsequently included in the U.S. shareholder's gross income) due to the shipping reinvestment rule.

Deficits attributable to shipping activities for taxable years beginning before 1987 would be available to reduce subpart F inclusions of income attributable to shipping activities only to the extent that such inclusions are not offset by deficits attributable to shipping activities for taxable years beginning after 1986.

Effective Date

The proposal would apply to taxable years of foreign corporations beginning after December 31, 1993.

7. Deferral of U.S. tax on certain reinvested foreign base company shipping income

Present Law

As described above in Item I.1, when a U.S.-controlled foreign corporation earns so-called "subpart F income," the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their respective pro-rata shares of that income. One category of income that is considered subpart F income is "foreign base company shipping income."

As described above in Item I.6, foreign base company shipping income that was reinvested by a controlled foreign corporation in foreign shipping operations was excluded from foreign base company income under pre-1986 Act law. The 1986 Act repealed the reinvestment exception to subpart F taxation.

Description of Proposals

One proposal would partially restore the reinvestment exception to subpart F taxation of foreign base company shipping income. The proposal generally would permit a controlled foreign corporation to reduce a portion of its foreign base company shipping income by the amount of its increases in foreign shipping investments, if the foreign corporation's controlled group also maintains a U.S.-flag shipping fleet that comprises at least four 10,000-ton vessels. The portion of foreign base company shipping income eligible for reduction by such reinvestments would be the portion that is properly allocable to the operation of vessels that the owner (or the demise charterer) agrees to make available to the United States in times of national emergency.

A second proposal also would partially restore the reinvestment exception to subpart F taxation of foreign base company shipping income, but would not require the foreign corporation's controlled group to maintain a U.S.-flag shipping fleet.

Effective Date

The proposals would apply to taxable years of foreign corporations beginning on or after January 1, 1993.

8. Treatment of certain investments of earnings of controlled foreign corporations in U.S. property

Present Law

As described above in Item I.1, when a U.S.-controlled foreign corporation earns so-called "subpart F income," the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their respective pro-rata shares of that income. Foreign income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment of a dividend to its U.S. stockholders.

In addition to taxation of subpart F income and taxation of actual repatriations of earnings (not previously taxed as subpart F income), a U.S. shareholder may also be subject to U.S. taxation on the controlled foreign corporation's current or accumulated earnings (other than earnings that were previously taxed to the U.S. shareholders as subpart F income), at the time of any increase for the year in the amount of those earnings invested by the controlled foreign corporation in U.S. property. Such increases of investments in U.S. property are treated, in effect, as deemed repatriations of earnings. U.S. property subject to this rule is defined broadly with certain specified exceptions. The list of exceptions includes obligations of the United States, bank deposits, stock or obligations of any domestic corporation that is neither a 10-percent U.S. shareholder of nor otherwise related to the controlled foreign corporation, and certain other exceptions.

Description of Proposal

The proposal would add a new exception to the definition of U.S. property for purposes of the taxation under subpart F of certain earnings of a controlled foreign corporation that are invested in U.S. property. Under the proposal, obligations of domestic persons that are not corporations, and are not 10-percent U.S. shareholders of the controlled foreign corporation, would not be treated as U.S. property for this purpose. Thus, for example, a controlled foreign corporation could use its earnings that have not been subject to U.S. tax to make loans to U.S. individuals and partnerships, without risk of taxation of those earnings under subpart F.

Effective Date

The proposal would be effective for taxable years of foreign corporations beginning after September 30, 1993, and for taxable years of domestic shareholders in which or with which such taxable years end.

9. Election to treat controlled contiguous country corporations as domestic corporations

Present Law

A corporation is considered to be a domestic (or U.S.) corporation if it is created or organized in the United States, or under the laws of the United States or the laws of a State or the District of Columbia. Domestic corporations are taxed currently by the United States on their worldwide income, subject to a credit for foreign income taxes against the U.S. tax on foreign income. A U.S. corporation (or other U.S. person) that conducts foreign operations through a foreign corporation generally pays no U.S. tax on the income from those operations until the foreign corporation repatriates its earnings to the United States. Nor, in general, can the foreign corporation join in the filing of a consolidated U.S. income tax return. Thus, losses of the foreign corporation generally may not be used to offset taxable income of a U.S. corporation.

In some cases, the Code permits a foreign corporation to be treated for tax purposes as though it were a U.S. corporation. For example, certain foreign corporations engaged in an insurance business are permitted to elect to be treated as domestic for most U.S. tax purposes (sec. 953(d)). In addition, certain corporations organized under the laws of contiguous countries (i.e., Canada or Mexico) and maintained solely for the purpose of complying with the laws of those countries as to title and operation of property may, at the option of a domestic parent corporation that owns or controls 100 percent of the corporation's capital stock (exclusive of directors' qualifying shares), be treated as domestic companies (sec. 1504(d); see also *U.S. Padding Corp. v. Commissioner,* 865 F.2d 750 (6th Cir. 1989)).

Description of Proposal

The proposal would modify the election to treat Canadian and Mexican corporations as domestic corporations. Under the proposal, the election would be available to all Canadian and Mexican corporations that would be members of the affiliated group (as defined for purposes of consolidated return filing, but without regard to the exclusion of foreign corporations from the group), without regard to whether the corporation is a foreign corporation solely for purpose of complying with local laws as to title and operation of property. In addition, all Canadian and Mexican corporations that would be members of the affiliated group would be treated as domestic corporations if an election is made by the domestic parent. The election could not be revoked without the consent of the IRS.

Effective Date

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

10. Revise application of interest allocation rules in the case of certain financial service providers

Present Law

In general

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S. source gross income, on the one hand, and items of foreign source gross income, on the other. Generally it is left to the Treasury to provide detailed rules for the allocation and apportionment of expenses.

In the case of interest expense, regulations generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. (Exceptions to the fungibility concept are recognized or required, however, in particular cases, some of which are described below.) The Code provides that, for interest allocation purposes, all members of an affiliated group of corporations generally are to be treated as a single corporation (the so-called "one-taxpayer rule"), and that allocation must be made on the basis of assets rather than gross income.

Affiliated group

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. However, some groups of corporations are eligible to file consolidated returns yet are not treated as affiliated for interest allocation purposes, and other groups of corporations are treated as affiliated for interest allocation purposes even though they are not eligible to file consolidated returns. Thus, under the one-taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another, related corporation even if the two corporations do not elect to file, or are ineligible to file, consolidated returns. (See, e.g., Treas. Reg. sec. 1.861-11T(g).)

Definition of affiliated group—consolidated return rules

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if the common parent owns directly at least 80 percent of the total voting power of all classes of stock and at least 80 percent of the total value of all outstanding stock of at least one other includible corporation. In addition, for each such other includible corporation (except the common parent), stock possessing at least 80 percent of the total voting power of all classes of its stock and at least 80 percent of the total value of all of its outstanding stock must be directly owned by one or more other includible corporations.

Generally the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation is not an includible corporation.

Definition of affiliated group—special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other. For example, both definitions exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rule does not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group. Moreover, Congress in 1986 expressly considered and rejected a rule that would have accomplished a result more consistent with world-wide fungibility by taking foreign members' borrowings into account when allocating the interest expense of the domestic members (H.R. 99-841, 99th Cong., 2d Sess. II-605 (1986)). In practice, the limit in the degree of fungibility recognized by present law can reduce the foreign tax credit limitations that otherwise would apply if the principle of fungibility were extended to foreign and domestic members of a commonly controlled group.

The statutory definition of affiliation for purposes of group-wide allocation of interest expenses expressly provides for two exceptions from the definition of affiliation for consolidation purposes, one of which contracts the affiliated group and the other of which expands it.

Banks, savings institutions and other financial affiliates

Under the first-mentioned exception, the affiliated group for interest allocation purposes generally excludes what are known in the regulations as "financial corporations" (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies and subsidiaries of banks, bank holding companies, and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other nonfinancial members of that group. Instead, all such financial corporations which would be so affiliated are treated as a separate single corporation for interest allocation purposes.

Regulatory adjustments of the affiliation rules

In addition to the express statutory differences between the consolidated return and interest allocation definitions of affiliation, regulations provide for further differences. Under the statutory rules requiring interest to be allocated on a group-wide basis, and more generally under the statutory rules for determining the foreign tax credit and the limitations applicable to the credit, the Treasury Department has been delegated the authority to resource the income of any member of an affiliated group or modify the consolidated return regulations to the extent such resourcing or modification is necessary to carry out the purposes of the statute. Temporary and proposed Treasury regulations provide that certain corporations not within the general definition of an affiliated group, such as any includible corporation if 80 percent of the vote *or* value of its stock is owned directly or indirectly by an includible corporation or by members of an affiliated group, will be considered to constitute affiliated corporations for purposes of the interest expense allocation rules (Treas. Reg. sec. 1.861-11T(d)(6)(i)).

Description of Proposal

The proposal would modify the Code's separate treatment for banks and other savings institutions defined in sections 581 and 591, and required by law to be operated separately from other nonbanking entities, by extending the same treatment to other corporations predominantly engaged in the conduct of a banking, financing, or similar business (not including an insurance business), the business of which is predominantly with persons other than related persons or their customers, and which are operated, not inconsistently with regulations prescribed by the Secretary, separately from any other entity which is not such an institution.

Effective Date

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

11. Section 936 treatment for income from investments in certain South American countries

Present Law

Certain domestic corporations with business operations in the U.S. possessions may elect the use of the section 936 credit which generally eliminates the U.S. tax on certain income related to their operations in the possessions. Income exempt from U.S. tax under this provision falls into two broad categories: business income, which in order to be exempt generally must be income treated as foreign source income derived from the active conduct of a trade or business within a U.S. possession; and investment income, which in order to be exempt must be derived from certain specified investments. The investment income exempted under this provision is known as "qualified possession source investment income" (QPSII).

The Code provides that QPSII is income of a possession corporation that (1) is from sources within a possession in which the corporation actively conducts a trade or business, and (2) is attributable to the investment in such possession (for use therein) of funds derived from the active conduct of a possession-based business or from such investment. An investment in a financial institution may be treated as for use in Puerto Rico to the extent it is used by such financial institution (or by the Government Development Bank for Puerto Rico or the Puerto Rico Economic Development Bank) for investment, consistent with the goals and purposes of the Caribbean Basin Economic Recovery Act, in active business assets or development projects in a qualified Caribbean Basin country.[45] This special rule does not apply to an investment made by a financial institution (or by the Government Development Bank for Puerto Rico or the Puerto Rico Economic Development Bank) unless (1) the person in whose trade or business such investment is made (or such other recipient of the investment) and the financial institution or such Bank certify to both the Treasury Secretary and the Commissioner of Financial Institutions of Puerto Rico that the proceeds of the loan will be promptly used to acquire active business assets or to make other authorized expenditures, and (2) the financial institution or Bank and the recipient of the investment funds agree to permit the Treasury Secretary and the Commissioner of Financial Institutions of Puerto Rico to examine such of their books and records as may be necessary to ensure that the above requirements are satisfied.

For this purpose, a "qualified Caribbean Basin country" means any beneficiary country (within the meaning of section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act) which meets the following two requirements, and the Virgin Islands. First, there must be in effect a bilateral or multilateral agreement between the country and the United States providing for the exchange of information between the United States and such country.[46] Second, there must not be in effect a finding by the Treasury Secretary that the tax laws of such country discriminate against conventions held in the United States.

Description of Proposal

The proposal would extend to income from qualified investments made in certain South American countries the QPSII treatment granted to income earned from investments in qualified Caribbean Basin countries. The proposal would apply to investments made in Bolivia, Colombia, Ecuador, and Peru. In order to qualify for QPSII treatment, the specified country would have to satisfy the above-described Tax Information Exchange Agreement and non-discrimination requirements.

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[45] The Code specifically requires that for each calendar year, the Government of Puerto Rico shall take such steps as may be necessary to ensure that at least $100 million of investments in qualified Caribbean Basin countries is made during such year. (sec. 936(d)(4)(D)).

[46] An exchange of information agreement shall provide for the exchange of such information (not limited to information concerning nationals or residents of the United States or the other country) as may be necessary or appropriate to carry out and enforce the tax laws of the two countries (whether criminal or civil proceedings), including information which may otherwise be subject to nondisclosure provisions of the local law of the other country such as provisions respecting bank secrecy and bearer shares. (sec. 274(b)(6)(C)(i)).

Effective Date

The proposal would be effective for income earned from investments made after the date of enactment of the proposal.

12. Allocation to U.S. source income of deductions for taxes paid to State and local governments

Present Law

Foreign tax credit and source rules

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

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, taxpayers are required to allocate and apportion expenses between foreign source income and U.S. source income (secs. 861-864). A shift in the allocation and apportionment of expenses from U.S. source to foreign source gross income decreases foreign source taxable income, and may increase U.S. tax by reducing the foreign tax credit limitation.

General rules for the allocation and apportionment of deductions

In general, the primary statutory rule for allocating and apportioning deductions between foreign and domestic income is that there shall be deducted from domestic and foreign source gross income, respectively, the expenses, losses, and other deductions "properly apportioned or allocated thereto" and "a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income" (secs. 861(b) and 862(b)). Furthermore, the Code provides that items of expense, loss, and deduction are to be allocated or apportioned to sources within or without the United States under regulations prescribed by the Secretary (sec. 863(a)).

As expressly provided in the statute, deductions not definitely related to gross income are apportioned on a pro-rata basis between domestic and foreign source gross income. The regulations contemplate two other types of deductions: (1) deductions definitely related to all of the taxpayer's gross income, and (2) deductions definitely related to a subset or "class" of the taxpayer's gross income. Division of the taxpayer's income into classes for this purpose, and determination of whether a particular deduction is related to that class, is based on the factual relationship between the deduction and the class of gross income. A deduction is considered definitely related to a class of gross income if it is incurred as a result of, or incident to, an activity or in connection with property from which that class of gross income is derived (Treas. Reg. sec. 1.861-8(b)(2)).

Once deductions are associated with the corresponding class of gross income (or all of gross income), an apportionment is made between the so-called "statutory grouping" of income in that class (for foreign tax credit purposes, generally the foreign source income within the particular foreign tax credit limitation category for which the limitation is being computed) and the so-called "residual grouping" (for foreign tax credit limitation purposes, generally all the rest of the income in the class not in the "statutory grouping").

Allocation of State and local taxes

The United States taxes U.S. persons on their worldwide income, while State governments and their political subdivisions generally tend to impose tax on a more territorially limited basis. Nevertheless, a State or local taxing jurisdiction may include in its income tax base, even for a corporate taxpayer, income that for Federal purposes would be foreign source income.[47] Therefore, Treasury regulations require that State and local income taxes be allocated to and apportioned between income from U.S. and foreign sources, on the principle that the deduction for State income taxes is definitely related to the gross income with respect to which those taxes are imposed (Treas. Reg. sec. 1.861-8(e)(6)).

General presumption

In order to determine the portion (if any) of a State or local jurisdiction's income tax that is allocated and apportioned to foreign source income, the regulations generally require that the allocation and apportionment be made by reference to the tax base (determined under State or local law) to which that jurisdiction's tax rate is applied. The regulations embody a presumption that State and local income taxes are allocable to a class of gross income that includes foreign source income when the State or local tax base exceeds the amount of U.S. source taxable income determined under the Code (disregarding the deduction for State and local income taxes). Under the regulations, generally State or local tax on the State or local tax base *not* in excess of Federally computed U.S. source income generally may be allocated to U.S. source income.

Modifications to the presumption

The general presumption is modified under the regulations in cases where a particular State or local law prohibits taxation of foreign source income; where the taxable income of the taxpayer is split among several States or localities, some of which have no income tax system; or where a State or local jurisdiction's law includes foreign source income in its apportionment formula base without a corresponding inclusion of foreign factors that would cause that foreign income to be apportioned out of the jurisdiction's income tax base.

As an example of the first modification, assume that a State uses an apportionment formula to determine the portion of a taxpayer's

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[47] For example, a State may include in its tax base dividends from foreign corporations which dividends would be foreign source income under Federal tax rules.

world-wide income which is to be taxed. Assume further that under State law all foreign source income, as determined by the Code, is exempt from State taxation and the State tax apportionment base, and State-law apportionment factors relating to foreign-source-income-producing operations are excluded from the State apportionment formula. In such a case the regulations indicate that none of that State's tax is allocated or apportioned to foreign source income (Treas. Reg. sec. 1.861-8(g), *Example 26*).

The regulation further provides for a refinement of the basic presumption when a taxpayer's income could be partly attributed to a State or local jurisdiction that imposes no income tax. Assume for example that a taxpayer has operations in two States. One State imposes tax on a base of $600,000, determined by formulary apportionment. The other State has no income tax. Federal taxable income (disregarding the State income tax deduction) is $1,000,000, of which $200,000 is foreign source. Because U.S. source taxable income includes income from transactions related to both States, before determining that the State tax on the $600,000 is solely tax on a portion of the $800,000 of U.S. source income, and therefore not allocable or apportionable at all to its foreign source income, the taxpayer must under the regulations first make an estimate of the amount of taxable income that *could* hypothetically be attributed to activities in the non-taxing State, using any reasonable method the taxpayer chooses. If the result of this estimate is that $200,000 or less of taxable income would reasonably be allocated to the non-taxing State, then the regulations suggest that none of the other State's tax need be allocated or apportioned to foreign source income. If the result is that more than $200,000 of taxable income would reasonably be allocated to the non-taxing State, then under the regulations a portion of the $600,000 would be allocated and apportioned to foreign source income (*see* Treas. Reg. sec. 1.861-8(g), *Example 27*).

A third regulatory exception to the general presumption concerns the case where a U.S. corporation receives foreign source "portfolio" dividends from a controlled foreign corporation, or dividends from the controlled foreign corporation the majority of the stock of which is not held by the U.S. taxpayer. In particular, the exception applies where State or local law includes those dividends in the taxpayer's apportionment formula base without a corresponding inclusion of factors of the controlled foreign corporation in the apportionment formula. (Were such factors so included, the State or local tax on the dividends could be diluted or completely eliminated through operation of the formula.) Where the factors of the controlled foreign corporation are not included, the regulation provides that a portion of the State or local tax is considered directly related to the amount of the dividend times the applicable apportionment fraction.

The regulations also permit taxpayers to elect to compare Federally computed U.S. source income with the State or local tax base using either a modified State or local tax base, or, under an elective safe harbor method of allocation and apportionment, a Federally computed tax base inflated by 10 percent. As an example of a modified State or tax base, assume that in a particular instance a State computes a taxpayer's State tax base as an amount greater than the taxpayer's Federally computed U.S. source income, but that the excess is due to a difference in the rate of allowable depreciation or the amount of another deduction that allowable under both the State and Federal income tax systems. The regulations contemplate that, with the approval of the District Director, the State tax base may be reduced (for Federal expense allocation purposes) to reflect more accurately the income with respect to which the State income tax is imposed (Treas. Reg. sec. 1.861-8(e)(6)(ii)(C)(*2*) and (g), *Example 31*), which may result in reduction or elimination of any allocation or apportionment of State tax to foreign source income. By contrast, a taxpayer is not permitted to modify the State income tax base of a formulary apportionment State for this purpose by reconstructing State income under a principle of separate entities dealing at arm's length (Treas. Reg. sec. 1.861-8(g), *Example 32*).

Finally, the regulations provide two elective safe harbor methods of allocation and apportionment. Once made, these elections must be followed every year unless revoked with the consent of the IRS. Under the first such method, there may be direct allocations of State or local tax to foreign source portfolio dividends, but there is, in general, no further apportionment of State or local income tax between remaining U.S. and foreign source income if the State- or local-law income tax base (after modifications to the presumed State tax base to account for jurisdictions without income taxes, as described above) does not exceed 110 percent of the U.S. source Federal tax base. If the State- or local-law income tax base *does* exceed 110 percent of the U.S. source Federal tax base, then under this safe harbor State or local tax is apportioned to U.S. source income in the proportion that 110 percent of the U.S. source Federal tax base (rather than 100 percent, as under the general presumption) bears to the entire State or local tax base (Treas. Reg. sec. 1.861-8(e)(6)(ii)(D)(*2*) and (g), *Example 33(ii)*).

Under the second safe harbor method, the State- or local-law income tax base is compared to 100 percent of the U.S source Federal tax base (again after making necessary modifications for no-tax States or localities). After direct allocations of State or local tax to foreign source portfolio dividends and to other foreign source income taxed by any State or locality that uses the worldwide unitary business theory of taxation, if necessary, an amount of State or local tax is apportioned to U.S. source income in the proportion that U.S. source Federal taxable income bears to the State or local income tax base. A further amount of State or local tax then is apportioned to U.S. source income in the proportion that U.S. source Federal taxable income bears to total *Federal* taxable income (Treas. Reg. secs. 1.861-8(e)(6)(ii)(D)(*3*) and (g), *Example 33(iii)*).

Description of Proposal

For purposes of computing the foreign tax credit limitation, the proposal would require all deductions for State or local income or franchise taxes to be allocated to U.S. source income.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1976.

13. Commodities income of a controlled foreign corporation

Present Law

As described above in item 1, when a U.S.-controlled foreign corporation earns so-called "subpart F income," the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their respective pro-rata shares of that income.

One category of income that is considered subpart F income is "foreign personal holding company income." Foreign personal holding company income generally consists of passive types of income such as interest, dividends, annuities, and net gains from the disposition of certain types of property. Subject to a number of exceptions, foreign personal holding company income includes the excess of gains over losses from transactions (including futures, forward, and similar transactions) in any commodities. Under one such exception, gains and losses from commodities transactions are not taken into account for purposes of measuring foreign personal holding company income if they are "active" business gains or losses from the sale of commodities, provided that *substantially all* of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities.[48]

Current temporary regulations interpret the statute by determining the amount of business that is "substantially all" of the CFC's business using a taxable income test.[49] Under the regulations, substantially all of a controlled foreign corporation's business is considered to be as an active producer, processor, merchant, or handler of commodities if its active commodities business operations give rise to at least 85 percent of its taxable income for the taxable year.

The legislative history to the Tax Reform Act of 1986 specified that the exception for active producers, processors, merchants, and handlers of commodities applies only to foreign corporations actively engaged in a commodities business.[50] It does not apply to foreign corporations primarily engaged in such financial transactions as the trading of futures. In order to be engaged in the active conduct of a commodities business, a controlled foreign corporation generally must hold commodities as inventory or similar property and incur substantial expenses in the ordinary course of a commodities business.[51] Regularly taking delivery of physical commodities generally indicates the existence of an active commodities business, but it does not of itself determine the issue. Other characteristics of companies actively engaged in a commodities business include: engaging in substantial processing activities and incurring substantial expenses with respect to commodities prior to

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[48] Other exceptions to the subpart F income classification of commodities gains and losses include an exception for bona fide hedging transactions and an exception for certain foreign currency gains and losses.

[49] Temp. Treas. Reg. sec. 1.954-2T(f)(3)(iv).

[50] S. Rep. No. 99-313, 99th Cong., 2d Sess. 367 (1986).

[51] Temp. Treas. Reg. sec. 1.954-2T(f)(3)(iii).

their sale, including (but not limited to) concentrating, refining, mixing, crushing, aerating, and milling; engaging in significant activities and incurring substantial expenses relating to the physical movement, handling, and storage of commodities, including (but not limited to) preparation of contracts and invoices, arrangement of freight, insurance, or credit, arrangement for receipt, transfer, or negotiation of shipping documents, arrangement of storage or warehousing, and dealing with quality claims; owning and operating physical facilities used in the activities described above; owning or chartering vessels or vehicles for the transportation of commodities; and producing the commodities sold.[52]

Description of Proposal

The proposal would expand the exception from the definition of foreign personal holding company income for active business gains and losses from the sale of commodities. Under the proposal, active business gains and losses from the sale of commodities by a controlled foreign corporation as an active producer, processor, merchant, or handler of commodities would not be taken into account for purposes of determining the foreign corporation's foreign personal holding company income. Thus, the proposal would eliminate the "substantially all" requirement of present law. As under present law, the exception would not apply to any gains or losses of a foreign corporation derived from primarily financial transactions (e.g., the trading of commodities futures), even if the foreign corporation also is engaged in an active commodities business as a producer, processor, merchant, or handler.

The proposal would not alter the present-law criteria for determining whether a foreign corporation is an active producer, processor, merchant, or handler of commodities. Thus, for example, in order to exclude commodity gains and losses under the active business exception, a controlled foreign corporation must hold the commodity giving rise to the gain or loss as inventory or similar property, and must regularly engage in the production, processing, or handling and storage of the commodity.

Effective date

The proposal would be effective for taxable years of foreign corporations beginning after December 31, 1993.

14. Increase in reporting threshold for stock ownership of a foreign corporation

Present Law

U.S. persons who own or acquire 5 percent or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership are required to file information returns concerning the corporation and its shareholders (sec. 6046; see schedule O (Form 5471)). Regulations excuse

[52] S. Rep. No. 99-313, at 367-368.

any shareholder from furnishing required information if it is furnished by another person having an equal or greater stock interest in the corporation (Treas. Reg. sec. 1.6046-1(e)(5)).

Description of Proposal

The proposal would increase the 5-percent reporting threshold to 10 percent.

Effective Date

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

15. Exempt certain income of foreign financing and credit services companies from the rules applicable to passive foreign investment companies

Present Law

As described above in Item I.1, U.S. persons generally are taxed currently by the United States on their worldwide income. Foreign income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment of a dividend to its U.S. stockholders.

If any foreign corporation (including a controlled foreign corporation) is a so-called "passive foreign investment company" (PFIC), U.S. persons (including 10-percent "U.S. shareholders") that own stock in the PFIC may be subject to one of two other sets of operating rules that eliminate or reduce the benefits of deferral (secs. 1291-1297). A PFIC generally is defined as any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of its assets consist of passive assets, defined as assets that produce, or are held for the production of, passive income (sec. 1296(a)).

Passive income does not include any income derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States, or, to the extent provided in regulations, by any other corporation (sec. 1296(b)(2)(A)). According to IRS Notice 89-81, 1989-2 C.B. 399, forthcoming Treasury regulations will provide that income effectively connected with the active conduct of a U.S. trade or business pursuant to a license to do business as a bank in the United States, as well as income derived in bona fide banking activities (as defined in Notice 89-81) conducted abroad by a U.S. licensed bank, will be treated as income other than passive income. In addition, a foreign corporation that is not licensed to do business as a bank in the United States, but that qualifies as an active foreign bank (or "qualified affiliate") under conditions set forth in Notice 89-81, will be permitted to treat its income derived in the performance of bona fide banking activities as not passive income.

In addition, passive income does not include any income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business, and which would be subject to U.S. taxation under the rules applicable to insurance companies if it were a domestic corporation (sec. 1296(b)(2)(B)).

Description of Proposal

The proposal would provide regulatory authority for the Secretary of the Treasury to exclude from the definition of passive income for purposes of the PFIC rules any income derived in the active conduct of the business of financing and credit services. This regulatory exception would parallel the exceptions available to banking and insurance income under present law.

Effective Date

The proposal would be effective for taxable years of foreign corporations beginning after September 30, 1993, and for taxable years of domestic shareholders in which or with which such taxable years end.

16. Extension of period to which excess foreign taxes may be carried

Present Law

The foreign tax credit is subject to an overall limitation. That is, the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year. In addition, the foreign tax credit limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of the credit for foreign taxes on income in each separate limitation category may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income in that category bears to its worldwide taxable income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back to the two immediately preceding taxable years and carried forward to the first five succeeding taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years. For purposes of determining excess foreign tax credit amounts, the foreign tax credit separate limitation rules apply. Thus, if a taxpayer has excess foreign tax credits in one separate limitation category for a taxable year, those excess credits are carried back and forward only as taxes allocable to that category notwithstanding the fact that the taxpayer may have excess foreign tax credit limitation in another category for that year.

Description of Proposal

The proposal would extend the excess foreign tax credit carryforward period from 5 to 15 years.

Effective Date

The proposal would be effective for taxable years beginning after date of enactment. It would apply only with respect to taxes actually paid or accrued (or deemed paid) by the taxpayer in such taxable years. The present-law carryforward period continues to apply with respect to taxes actually paid or accrued (or deemed paid) by the taxpayer in taxable years beginning on or before date of enactment.

J. Natural Resources Provisions

1. Timber provisions (H.R. 1997)

a. Reduce capital gains on timber for domestic processing

Present Law

A taxpayer who owns timber or who possesses the right to cut timber may elect to treat the cutting of the timber as a sale or exchange of the timber for Federal income tax purposes if the timber or the right to cut the timber has been held for more than one year before the cutting and the timber is cut for sale or for use in the taxpayer's trade or business. In addition, the gain or loss from the disposition of timber by a taxpayer under a contract pursuant to which an economic interest is retained by the taxpayer is treated as if the gain or loss were from the sale or exchange of the timber for Federal income tax purposes if the timber has been held for more than one year before the disposition.

The gain or loss from any such sale or exchange is treated as a gain or loss from the sale or exchange of trade or business property for purposes of section 1231. Under section 1231, any gain from the sale or exchange of trade or business property that is held for more than one year is treated as long-term capital gain if the total gain from the sale or exchange of such property for any year exceeds the total loss from the sale or exchange of such property for such year.

Consequently, the cutting of timber and the disposition of timber under a contract pursuant to which an economic interest was retained generally qualify for the favorable Federal income tax treatment accorded the sale or exchange of capital assets despite the fact that the gain would otherwise be treated as ordinary income because under general tax principles (1) a sale or exchange had not occurred or (2) the timber was held primarily for sale to customers in the ordinary course of a trade or business.[53]

Description of Proposal

The proposal is section 2 of H.R. 1997. H.R. 1997 would provide that taxpayers may elect to exclude a portion of gain realized on the sale or other disposition of certain timber. Any taxpayer who has a qualified timber gain may elect to deduct from gross income an amount equal to the qualified percentage of such gain. The qualified percentage is equal to two percent multiplied by the number of years the timber has been held by the taxpayer. The exclusion may not be greater than 30 percent.

Qualified timber is any timber for which the taxpayer has provided assurances, under Treasury regulations, that substantially all of the processing of the timber will occur within the United States.

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[53] The special rules that accord capital gains treatment to the cutting of timber or the disposition of timber under a contract pursuant to which an economic interest was retained were enacted as part of the Revenue Act of 1943. The legislative history to the Revenue Act of 1943 indicates that the special rules were necessary in order to treat taxpayers who cut their own timber or dispose of their timber under a contract pursuant to which an economic interest is retained in the same manner as taxpayers who sell their timber outright.

Effective Date

Section 2 of the bill would be effective on the date of enactment.

b. Amend certain provisions relating to the export of unprocessed timber

Present Law

In general

The Internal Revenue Code contains certain provisions, applicable to U.S. persons and to foreign corporations owned by U.S. persons, that are designed to encourage the export of goods, including timber, from the United States.

Rules for sourcing income

In general

Rules determining the source of income are important because the United States acknowledges that foreign countries have the first right to tax foreign income, but the United States generally imposes its full tax on U.S. income. The mechanism by which this is carried out in the case of a U.S. person, whose worldwide income is potentially subject to U.S. taxation, is the foreign tax credit limitation; and the source rules primarily are important for U.S. persons insofar as these rules determine the amounts of their foreign tax credit limitations.[54] For the foreign tax credit mechanism to function, every item of income must have a source: that is, it must be treated as having arisen either within the United States or outside the United States.

In computing the foreign tax credit limitation, taxable income from foreign sources is arrived at by (1) determining the items of gross income that are from foreign sources, and then (2) subtracting from that amount of gross income that portion of the taxpayer's deductions that are allocable to foreign source gross income. A shift in the source of income from foreign to U.S. may increase U.S. tax by decreasing the foreign tax credit limitation. Conversely, a shift in the source of income from U.S. to foreign may decrease U.S. tax by increasing the foreign tax credit limitation, thus permitting the taxpayer to claim additional foreign tax credits.

Sales of inventory property

Subject to significant exceptions, income from the sale of personal property generally is sourced on the basis of the residence of the seller. One set of exceptions applies to sales of inventory property. Income derived from the purchase of inventory property within the United States and its sale outside the United States constitutes foreign source income. Similarly, income derived from the purchase of inventory property outside the United States and its sale within the United States constitutes domestic source income. Income attributable to the marketing of inventory property by U.S. residents in other cases may also have its source based on the

[54] The foreign tax credit for any year may not exceed the following amount: (a) pre-credit U.S. tax, multiplied by the quotient of (b) foreign source taxable income divided by (c) entire taxable income (sec. 904(a)).

place of sale. For this purpose, the place of sale generally is the place where title to the property passes to the purchaser (the "title passage" rule).

Income derived from the manufacture of products in the United States and their sale elsewhere is treated as having a divided source. Under Treasury regulations, 50 percent of such income generally is attributed to the place of production (in this case, the United States), and 50 percent of the income is attributed to marketing activities and is sourced on the basis of the place of sale (determined under the title passage rule). Under certain circumstances, the division of the income between production and marketing activities must be made on the basis of an independent factory or production price, rather than on a 50-50 basis, where a taxpayer sells part of its output to wholly independent distributors or other selling concerns in such a way as to establish fairly the independent factory or production price unaffected by considerations of tax liability (Treas. Reg. sec. 1.863-3(b)(2), *Example (1)*; Notice 89-10, 1989-4 I.R.B. 10).

In many cases, income which is treated as having a foreign source under the title-passage rule does not bear any foreign tax. Because such untaxed foreign source income increases a taxpayer's foreign tax credit limitation, it may allow the taxpayer to claim credit for high foreign taxes paid on other foreign source income that otherwise would not be creditable.

Income earned by foreign corporations

The United States exerts jurisdiction to tax all income, whether derived in the United States or elsewhere, of U.S. citizens, residents, and corporations. By contrast, the United States taxes nonresident aliens and foreign corporations only on income with a sufficient nexus to the United States. In the case of income earned by a U.S.-owned foreign corporation, generally no U.S. tax is imposed until that income is distributed to the U.S. shareholders as a dividend.

As described above in Item I.1., when a U.S.-controlled foreign corporation earns so-called "subpart F income," the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro-rata share of that income. One category of income that is considered subpart F income is "foreign base company sales income."

Foreign sales corporations

As described above in Item I.3., a portion of the income of an eligible foreign sales corporation (FSC) that is generated from export property is exempt from Federal income tax. In addition, a domestic corporation is allowed a 100-percent deduction for dividends received from the FSC out of earnings attributable to certain foreign trade income. Thus, there generally is no corporate level tax imposed on a portion of the income from export property of a FSC.

Export property, for purposes of the FSC rules, is defined as property that is (1) manufactured, produced, grown, or extracted in the United States by a person other than a FSC, (2) held primarily for sale, lease, or rental, in the ordinary conduct of a trade or business by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

Domestic International Sales Corporations

Prior law provided for a system of tax deferral for corporations known as Domestic International Sales Corporations (or "DISCs") and their shareholders. Under this system, the profits of a DISC were not taxed to the DISC but were taxed to the shareholders of the DISC when distributed or deemed distributed to them. Each year, a DISC was deemed to have distributed a portion of its income, thereby subjecting that income to current taxation in its shareholders' hands. Federal income tax could generally be deferred on the remaining portion of the DISC's taxable income until the income was actually distributed to the shareholders.

Under current law, a DISC is permitted to continue to defer income attributable to $10 million or less of qualified export receipts. However, unlike the prior-law DISC rules, an interest charge is imposed on the shareholders of the DISC. The amount of the interest is based on the tax otherwise due on the deferred income computed as if the income were distributed. Taxable income of the DISC attributable to qualified export receipts that exceed $10 million is deemed distributed to the DISC's shareholders.

To qualify for DISC treatment, at least 95 percent of a domestic corporation's gross receipts must consist of qualified export receipts. In general, qualified export receipts are receipts, including commission receipts, derived from the sale or lease for use outside the United States of export property, or from the furnishing of services related or subsidiary to the sale or lease of export property. Export property must be manufactured, produced, grown, or extracted in the United States.

Description of Proposal

The bill (H.R. 1997) would amend certain provisions of the Internal Revenue Code as they apply to exporters of unprocessed timber. For this purpose, the term "unprocessed timber" has the same meaning as that given to it in the Customs and Trade Act of 1990 (104 Stat. 629). That Act defines unprocessed timber as trees or portions of trees or other roundwood not processed to standards and specifications suitable for end product use. The term unprocessed timber does not include timber processed into any one of the following: (1) lumber or construction timbers, except Western Red Cedar, meeting current American Lumber Standards Grades or Pacific Lumber Inspection Bureau Export R or N list grades, sawn on 4 sides, not intended for remanufacture; (2) lumber, construction timbers, or cants for remanufacture, except Western Red Cedar, meeting current American Lumber Standards Grades or Pacific Lumber Inspection Bureau Export R or N list clear grades, sawn on 4 sides, not to exceed 12 inches in thickness; (3) lumber, construction timbers, or cants for remanufacture, except Western Red Cedar, that do not meet the grades referred to in (1) or (2) and are sawn on 4 sides, with wane less than 1/4 of any face, not exceeding 8.75 inches in thickness; (4) chips, pulp, or pulp products; (5) veneer or plywood; (6) poles, posts, or piling cut or treated with preservatives for use as such; (7) shakes or shingles; (8) aspen or other pulpwood bolts, not exceeding 100 inches in length, exported for processing into pulp; or (9) pulp logs or cull logs processed at domestic pulp mills, domestic chip plants, or other domestic operations for the purpose of conversion of the logs into chips.

The bill would exclude from the definition of "export property" for purposes of the FSC rules any unprocessed timber. Similarly, the bill would exclude from the definition of "export property" for purposes of the DISC rules any unprocessed timber.

The bill also would amend the sales source rules as they apply to inventory property. In this case, the bill provides that any income from the sale of any unprocessed timber which is a softwood and was cut from an area located in the United States would be domestic source income.

Finally, the bill would treat as subpart F foreign base company sales income any income derived by a controlled foreign corporation in connection with the sale of any unprocessed timber which is a softwood and was cut from an area located in the United States. In addition, the bill would treat as subpart F foreign base company sales income any income derived by a controlled foreign corporation from the milling of any such timber outside the United States.

Another bill, H.R. 1542, contains similar proposals with minor technical differences.

Effective Date

The bill would be effective for transactions occurring after date of enactment.

2. Repeal related-party sales requirement for nonconventional fuels production credit

Present Law

Certain nonconventional fuels are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or Btu oil barrel equivalent (sec. 29). Qualified fuels must be produced domestically from a well drilled, or a facility placed in service (or treated as placed in service under special rules enacted in 1992), before January 1, 1993. The credit generally is available for qualified fuels produced by the taxpayer and sold to unrelated persons before January 1, 2003.

Fuels that qualify for the credit include (1) oil produced from shale and tar sands, (2) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass (i.e., any organic material other than oil, natural gas, or coal (or any product thereof)), and (3) liquid, gaseous, or solid synthetic fuels produced from coal, including such fuels when used as feedstocks.

The credit applies to qualified fuels that are sold to persons other than related persons by the taxpayer during the taxable year. For this purpose, persons are considered related to one another if they would be treated as a single employer under regulations promulgated under Code section 52(b).

Description of Proposal

Under the proposal, a taxpayer would be treated as selling a qualified fuel to an unrelated person if the taxpayer uses the fuel at the site of production to generate electricity which is sold to an unrelated person. Application of the proposal would be limited to electricity generated from either (1) gas produced from biomass or (2) liquid, gaseous, or solid synthetic fuels produced from coal. The proposal would permit the Treasury Department to issue regulations that would limit the scope of the proposal to taxpayers who use industry-accepted methods of metering the quantity of qualified fuels produced and used to generate electricity.

Effective Date

The proposal would be effective for the production of qualified fuels from facilities the original use of which commences after 1993.

3. Tax credit for oil and gas produced from marginal properties

Present Law

Tax credit for oil and gas production

Generally, no income tax credit is allowed for the production of crude oil and natural gas. As described above in Item J.2., an exception to this general rule applies, however, to the production of fuels from certain nonconventional sources—including, for this purpose, some categories of crude oil and natural gas (sec. 29). Specifically, fuels qualifying for the nonconventional fuels production credit include oil produced from shale and tar sands, and gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass (i.e., any organic material other than oil, natural gas, or coal (or any product thereof)).

The nonconventional fuels production credit may not offset a taxpayer's alternative minimum tax liability. Moreover, any such credit which is unused by a taxpayer for a taxable year generally may not be carried back or forward for use in other taxable years.

Enhanced oil recovery credit

As part of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"),[55] Congress enacted a provision that allows an income tax credit for a portion of certain expenditures incurred by taxpayers with respect to qualifying enhanced oil recovery projects (sec. 43). The credit is equal to 15 percent of a taxpayer's qualified enhanced recovery costs. Such costs include the following if paid or incurred with respect to a qualified enhanced oil recovery project: (1) the cost of tangible property which is an integral part of the project and with respect to which depreciation or amortization is allowable; (2) intangible drilling and development costs; and (3) the cost of tertiary injectants.

Qualified enhanced oil recovery projects generally include the application (in accordance with sound engineering principles) of a

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[55] P.L. 101-508.

qualifying tertiary recovery method to a domestic property where the application of the method can reasonably be expected to result in more than an insignificant increase in the amount of crude oil which will ultimately be recovered from the property. Qualifying tertiary recovery methods include miscible fluid displacement, steam-drive injection, microemulsion flooding, in situ combustion, polymer-augmented water flooding, cyclic-steam injection, alkaline (or caustic) flooding, carbonated water flooding, and immiscible gas displacement (e.g., carbon dioxide or other immiscible non-hydrocarbon gas) or any other method to provide tertiary enhanced recovery which is approved by the Secretary of the Treasury.

The enhanced oil recovery credit is a component of the general business credit (sec. 38). A taxpayer's general business credit for any taxable year may not offset its alternative minimum tax liability. Unused general business credits generally may be carried back three taxable years and carried forward 15 taxable years.

Percentage depletion attributable to oil and gas production from marginal properties

Independent oil and gas producers and owners of royalty interests in domestic oil and gas producing properties may deduct an allowance for percentage depletion in computing taxable income. Integrated oil and gas companies may not claim a deduction for percentage depletion. The percentage depletion allowance for oil and gas is calculated as a fixed percentage of the taxpayer's gross income from the oil or gas producing property, subject to limitations based on the net income produced from the property, the taxpayer's total production of oil and gas, and the taxpayer's taxable income.

The 1990 Act also included a provision that amended the percentage depletion rules (sec. 613A(c)(6)). Under this provision, which affects the percentage depletion deduction only with respect to marginal production, the general statutory percentage depletion rate of 15 percent for oil and gas is increased by one percent (up to a maximum rate of 25 percent) for each whole dollar that the average price of crude oil for the immediately preceding calendar year is less than $20 per barrel. The increased rate applies for the taxpayer's taxable year which immediately follows a calendar year for which the average crude oil price falls below the $20 floor.

For this purpose, the term marginal production means crude oil or natural gas that is produced from a domestic property which is (1) a stripper well property for the calendar year in which the taxpayer's taxable year begins, or (2) a property substantially all of the production from which during the calendar year is heavy oil. The Code defines a stripper well property as any property with respect to which the average daily per-well production for the year is 15 or less equivalent barrels of oil and gas. Heavy oil is oil that has a weighted average gravity of 20 degrees API or less corrected to 60 degrees Fahrenheit.

The determination of whether a property qualifies as a stripper well property is made separately for each calendar year, and is based on the total amount of production from the property for the year. A person who owns a partial interest in an oil or gas producing property must take into consideration total production from the property for the year, including the portion of such production which is attributable to ownership interests other than his or her own, in determining whether the property is a stripper well property.

Description of Proposal

The proposal would create a new income tax credit for the sale of domestically produced crude oil and natural gas from marginal properties. The credit would be available to any person that owns a working interest in a marginally-producing property; it would not be available to royalty-interest owners. The credit would not be a component of the general business credit.

For purposes of the proposal, the term "marginal property" would be defined differently, and the credit would be computed differently, for (1) newly drilled wells into proven properties, (2) newly drilled wells into unproven properties, and (3) wells existing on date of enactment of the proposal. With respect to all newly drilled wells, the credit would be available only if the well is located on a property the per-well production from which does not exceed the equivalent of 25 barrels of oil and gas per day. For this purpose, the volume of gas production from a property would be converted into oil-barrel equivalents using a conversion ratio of 6 Mcf per barrel of oil.

For production from newly drilled wells into already producing properties, the credit would be equal to (1) $1.49 per barrel for the first three barrels of oil produced per day from the well during a taxable year or (2) $0.50 per Mcf for the first 90 Mcf of gas produced per day from the well during the year.

In the case of production from newly drilled wells into properties that have no other production as of date of enactment, the credit would be equal to (1) $1.49 per barrel for the first 15 barrels of oil produced per day from the well during a taxable year or (2) $0.50 per Mcf for the first 90 Mcf of gas produced per day from the well during the year.

For production from wells existing on the date of enactment, the credit would apply if the well is part of a property that is considered a "stripper well property" pursuant to the 1990 legislation enacted to provide enhanced percentage depletion benefits to owners of such properties as described above (i.e., the per-well production from the property does not exceed the equivalent of 15 barrels per day). For such wells, a credit of $1.49 per barrel would apply for the first three barrels of daily production of oil; a credit of $0.257 per barrel would apply for the first 18 Mcf of daily production of gas.

The proposed credit would not be allowed for production from any well if the production also qualifies for the nonconventional fuels production credit. Once that credit expires, however, subsequent production from a such a well would qualify for the marginal production credit.

The marginal production credit would be permitted to offset, in full, the regular tax and the alternative minimum tax. Any unused credits generally could be carried back 3 taxable years (but not to taxable years preceding the effective date of the proposal) and carried forward 15 taxable years.

The credit would not be allowed for production from wells located offshore or from wells located in Alaska or Hawaii.

Effective Date

The effective date of the proposal would coincide with the effective date of the proposed Btu-based energy tax which is included in H.R. 2264, as passed by the House of Representatives on May 27, 1993. That is, the proposal would be effective for production on or after July 1, 1994. Moreover, the credit rates would be phased in proportionally with the Btu tax rates on oil and gas, and would be indexed in the manner provided for indexing the Btu tax rates.

4. Determination of independent oil and gas producer status

Present Law

Persons who own economic interests in oil and gas producing properties may deduct an allowance for depletion in computing taxable income (sec. 611). Independent oil and gas producers and persons who own royalty interests in oil and gas producing properties are permitted to deduct the greater of cost or percentage depletion on production of up to 1,000 barrels per day of crude oil and natural gas produced from domestic sources. The percentage depletion deduction for oil and gas is computed as a fixed percentage (generally, 15 percent) of the taxpayer's gross income from the oil or gas property, subject to net income and taxable income limitations.

Taxpayers are permitted the option to elect to deduct intangible drilling and development costs (IDCs) in the case of domestically located oil and gas wells (sec. 263(c)). For taxpayers other than independent oil and gas producers, however, 30 percent of the otherwise deductible amount of IDCs must be capitalized and recovered over a 60-month period.

As part of the Energy Policy Act of 1992,[56] Congress provided exceptions from inclusion in alternative minimum taxable income for IDCs and percentage depletion related to oil and gas properties that otherwise would be considered items of tax preference for purposes of computing the alternative minimum tax. These exceptions apply to independent oil and gas producers, but not to integrated oil and gas companies.

A producer of oil or natural gas is considered an independent producer unless that person (or a related person) also is engaged in a significant amount of either retailing or refining activity. A taxpayer meets the retailing exception (sec. 613A(d)(2)), and is thus not considered an independent producer, if the taxpayer directly, or through a related person, sells oil or natural gas (excluding bulk sales of such items to commercial or industrial users) or any product derived from oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense) through a retail outlet operated by the taxpayer (or a related person).[57] The retailer exception

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[56] P.L. 102-486.

[57] Sales by the taxpayer to any person (1) obligated under an agreement or contract with the taxpayer to use a trademark, trade name, or service mark or name of the taxpayer in marketing the oil, natural gas, or product derived therefrom, or (2) given authority, pursuant to an agreement or contract with the taxpayer (or related person) to occupy any retail outlet owned, leased, or controlled by the taxpayer, are treated as retail sales made by the taxpayer for this purpose.

applies to a taxpayer with combined gross receipts from retail sales of oil, natural gas, or petroleum products for a taxable year of more than $5 million.

A taxpayer is treated as a refiner, and thus is excluded from independent producer status, if the taxpayer or a related person engages in the refining of crude oil and on any day during the taxable year the refinery runs of the taxpayer (and related persons) exceed 50,000 barrels.

For purposes of the retailer and refiner exceptions, a person is a related person with respect to the taxpayer if a significant ownership interest (i.e., 5 percent or more) in either the taxpayer or such person is held by the other, or if a third person has a significant ownership interest in both the taxpayer and such person.

Description of Proposal

The proposal would amend the determination of whether a taxpayer is an independent oil and gas producer under the retailer and refiner exceptions. With respect to the retailer exception, the proposal would permit gross receipts from retail sales of natural gas by a regulated public utility that is a related party to be disregarded in determining whether a taxpayer is a retailer. For example, assume a producer of oil and gas has retail sales of natural gas by a related regulated public utility during a taxable year of $10 million, but has no other retail sales of natural gas or of oil or petroleum products. Under the proposal in this case, the taxpayer would be treated as an independent oil and gas producer since the regulated public utility retail sales of natural gas would be disregarded and thus, its retail sales for the year would not exceed $5 million.[58] As such, the taxpayer would be eligible for the above-described benefits available only to independent producers. For this purpose, the term "regulated public utility" would be as defined in section 7701(a)(33) of the Code, except that the company would be required to generate at least one-half of its gross income for the taxable year from sources described in subparagraphs (A), (B), and (C) of that section.

Also under the proposal, for purposes of determining significant refining activity under the refining exception, the requirement that a refinery run in excess of 50,000 barrels occur *on any day* during the taxable year would be eliminated. Instead, the proposal would require that the taxpayer's *average* daily refinery runs for the taxable year exceed 100,000 barrels in order not to treat the taxpayer as an independent producer under the refiner exception. (An alternative proposal would require that the taxpayer's *average* daily refinery runs for the taxable year exceed 75,000 barrels in order not to treat the taxpayer as an independent producer under the refiner exception.)

Effective Date

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

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[58] This example assumes that the taxpayer (or a related person) does not otherwise engage in significant levels of crude oil refining.

5. "The Renewables and Energy Efficiency Incentives Act of 1993" (H.R. 2026)

a. Permit energy credits to offset alternative minimum tax

Present Law

Nonrefundable business energy income tax credits are allowed for 10 percent of the cost of qualified solar and geothermal energy property (sec. 48(a)). Solar energy property that qualifies for the credit includes any equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat. Qualifying geothermal property includes equipment that produces, distributes, or uses energy derived from a geothermal deposit, but, in the case of electricity generated by geothermal power, only up to (and not including) the electrical transmission stage.

In 1992, Congress enacted a provision that allows an income tax credit for the production of electricity from either qualified wind energy or qualified "closed-loop" biomass facilities (sec. 45). The credit is equal to 1.5 cents (adjusted for inflation) per kilowatt hour of electricity produced from these qualified sources during the 10-year period after the facility is placed in service.

The business energy tax credits and the credit for electricity produced from wind or closed-loop biomass are components of the general business credit (sec. 38(b)(1)). These credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back 3 taxable years and carried forward 15 taxable years.

Description of Proposal

Section 101 of H.R. 2026 would allow the business energy tax credits and the credit for the production of electricity from renewable sources to offset 25 percent of the taxpayer's tentative minimum tax.

Effective Date

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

b. Make small wind turbines eligible for the business energy credits

Present Law

As described above in Item J.5.a., income tax credits are allowed for 10 percent of the cost of qualified solar and geothermal energy property. Also, as described above, a taxpayer may claim an income tax credit equal to 1.5 cents multiplied by the kilowatt hours of electricity produced by the taxpayer from a qualified wind facility.

Description of Proposal

Under section 102 of H.R. 2026, investments in small wind turbines would qualify for the business energy tax credits under section 48 of the Code. For this purpose, a small wind turbine would be defined as equipment which uses wind energy to generate electricity but only if the equipment has a rated capacity of no more than 50 kilowatts and is not primarily used for the production of electricity for sale to an unrelated person.

Effective Date

The bill would be effective for property placed in service after December 31, 1993.

c. Permit lessees of qualified facilities to claim renewable energy production credit

Present Law

As described above in Item J.5.a., a credit against income tax liability is provided for electricity produced from either qualified wind energy or qualified "closed-loop" biomass facilities (sec. 45).

The credit applies to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999, and to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before July 1, 1999. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

Description of Proposal

Section 103 of H.R. 2026 would permit any taxpayer that operates a qualified facility to claim the credit under section 45 of the Code for electricity production attributable to the taxpayer and sold to an unrelated party, regardless of whether the taxpayer owns or leases the facility.

Effective Date

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

d. Amend definition of solar energy property for purposes of the business energy credits

Present Law

As described above in Item J.5.a., business energy income tax credits are allowed for 10 percent of the cost of qualified solar and geothermal energy property (sec. 48(a)). Solar energy property that qualifies for the credit includes any equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat. Under regulations, certain types of solar energy property do not qualify for the credit if the property is part of a system that can also utilize nonsolar energy sources, unless the portion of solar-energy inputs to the system (measured annually) is at least 75 percent. (Treas. Reg. sec. 1.48-9(d).)

Description of Proposal

Section 104 of H.R. 2026 would broaden the class of solar energy equipment eligible for the business energy tax credits. Under the proposal, solar equipment comprising part of an energy system with respect to which the portion of solar energy inputs to the system (measured annually) is at least 50 percent of overall energy inputs would be treated as qualifying property.

Effective Date

The bill would be effective for property placed in service after December 31, 1993.

e. Expensing allowance for large electric vehicles

Present Law

An income tax credit equal to 10 percent of the cost of a qualified electric vehicle is allowed for vehicles placed in service by the taxpayer during the taxable year. The amount of the credit may not exceed $4,000 per vehicle. For this purpose, "qualified electric vehicle" means any motor vehicle (1) that is powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electric current; (2) the original use of which commences with the taxpayer; and (3) that is acquired for use by the taxpayer and not for resale.

A taxpayer is allowed to deduct an amount equal to the cost of any qualified clean-fuel vehicle property in the year such property is placed in service. The amount of the deduction is limited to: (1) $50,000 in the case of a truck or van with a gross vehicle weight rating greater than 26,000 pounds or a bus with a seating capacity of at least 20 adults (not including the driver); (2) $5,000 in the case of a truck or van with a gross vehicle weight rating greater than 10,000 pounds but not greater than 26,000 pounds; and (3) $2,000 in the case of any other motor vehicle. The term "qualified clean-fuel vehicle property" means property (1) that meets certain applicable emission standards; (2) the original use of which commences with the taxpayer; and (3) that is acquired for use by the taxpayer and not for resale. The term does not include any qualified electric vehicle. If any vehicle may be propelled by both a clean-burning fuel and any other fuel, the deduction is only allowed with respect to the incremental cost of permitting the use of the clean-burning fuel.

The credit and the expensing allowance are phased-out for vehicles placed in service after 2001, and expire after December 31, 2004. For both purposes, the term "motor vehicle" means any vehicle that is manufactured primarily for use on public streets, roads, and highways (not including a vehicle operated exclusively on a rail or rails) and that has at least four wheels.

Description of Proposal

Section 201 of H.R. 2026 would provide that any truck or van with a gross vehicle weight rating greater than 26,000 pounds or a bus with a seating capacity of at least 20 adults (not including the driver) that otherwise qualifies as both a qualified clean-fuel vehicle property and as a qualified electric vehicle would be treated as a qualified clean-fuel vehicle property. Thus, such property would be eligible for the expensing allowance and not the tax credit.

Effective Date

The bill would be effective for property placed in service after December 31, 1993.

f. Deduction for energy conservation expenditures by certain utilities

Present Law and Background

Regulated utilities have undertaken a variety of programs to reduce the use of energy by residential and business customers. The programs have taken different forms. Some programs provide reduced utility rates to consumers that volunteer to have power diminished during certain peak periods. Other programs provide cash rebates to consumers that purchase or install energy efficient appliances or devices from third party vendors. The ratemaking treatment of these programs by public utility commissions (PUCs) also varies. Some PUCs allow the utility to recover only the utility's cost of the program; others allow the utility to earn a rate of return on the cost of the program.

A provision in the Energy Policy Act of 1992 provides an exclusion from gross income for all or a portion of the value of the subsidies received by utility customers pursuant to such programs. However, no provision of the Internal Revenue Code or regulations specifically addresses the proper Federal income tax treatment of the costs of such programs by the regulated utility. It is understood that most utilities likely deduct such costs in the year the costs are paid or incurred. However, the Internal Revenue Service may find that such costs provide a benefit for a future period and may require such costs to be capitalized and recovered over time.[59]

Description of Proposal

Section 202 of H.R. 2026 (and H.R. 784) would provide that an electric or gas utility may deduct the amount of energy conservation expenditures paid or incurred by the taxpayer during the taxable year. For this purpose, "energy conservation expenditures" means expenditures for (1) subsidies provided directly or indirectly to customers for the purchase, installation, or modification of any device or service primarily designed to reduce consumption of electricity, natural gas, or steam, or to improve the management of en-

[59] See, for example the discussion in private letter ruling 9128010. In the ruling, the IRS allowed costs associated with an energy conservation program to be deducted in the year incurred, but stated that it may be appropriate to capitalize costs of similar programs under certain circumstances.

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ergy demand, or any specially defined energy property (as defined by section 136(c)(2)(A)); (2) energy use consulting and audits of commercial, residential, and industrial properties; or (3) administrative, promotional, and other costs associated with expenditures described above. The term would not include any expenditure taken into account in determining the basis of any tangible property that is owned by the taxpayer and that is of a character subject to an allowance for depreciation.

Effective Date

The bill would be effective for expenditures paid or incurred in taxable years beginning after December 31, 1980.

g. Provide full exclusion from income for energy conservation subsidies

Present Law

A provision of the Energy Policy Act of 1992 (the "1992 Act") provides an exclusion from the gross income of a residential customer of a public utility for the value of any subsidy provided by the utility for the purchase or installation of an energy conservation measure with respect to a dwelling unit.

In addition, the 1992 Act provided an exclusion from the gross income of a commercial or industrial customer of a public utility for 65 percent of the value of any subsidy provided by the utility after 1996 for the purchase or installation of an energy conservation measure with respect to property that is not a dwelling unit. The exclusion for commercial and industrial customers is phased in at 40 percent for subsidies provided in 1995, and 50 percent for subsidies provided in 1996.

Description of Proposal

Section 203 of H.R. 2026 would provide a 100-percent exclusion from the gross income of a commercial or industrial customer of a public utility for the value of any subsidy provided by the utility for the purchase or installation of an energy conservation measure.

Effective Date

The bill would be effective for subsidies provided after December 31, 1993.

h. Reduce credit and exemption for certain alcohol motor fuels

Present Law

Alcohol fuels credit

A 54-cents-per-gallon income tax credit is allowed to producers and blenders of ethanol alcohol (including ETBE) for use as fuel, or mixed with fuel in a mixture used as fuel. A 60-cents-per-gallon income tax credit is allowed to producers and blenders of alcohol other than ethanol that is used for the same purposes.

The amount of any person's allowable alcohol fuels tax credit is reduced to take into account any benefit received with respect to the alcohol under the excise tax exemptions for alcohol fuels mixtures or alcohol fuels (described below).

Excise tax exemptions for alcohol fuels mixtures and alcohol fuels

Alcohol fuels mixtures.—Present law reduces the excise taxes on certain mixtures of (1) ethanol and (2) gasoline, diesel fuel, or special motor fuels by 54-cents-per-gallon of alcohol that is mixed with these fuels. The reduction is 60-cents-per-gallon for alcohol other than ethanol that is used for the same purposes.

Neat alcohol fuels.—A 5.4-cents-per-gallon and 6.0-cents-per-gallon exemption from the excise tax on special motor fuels is provided for certain neat ethanol and methanol fuels, respectively, derived from a source other than petroleum or natural gas. Neat alcohol fuels are fuels comprised of at least 85 percent ethanol, methanol, or other alcohol.

Description of Proposal

Section 301 of H.R. 2026 would reduce the 54-cents-per-gallon income tax credit for ethanol alcohol that is used as a fuel, or mixed with fuel in a mixture that is used as fuel, to 35 cents per gallon. The proposal also would reduce the 54-cents-per-gallon-of-ethanol excise tax reduction to 35 cents per gallon for ethanol fuel mixtures. Further, the proposal would reduce the 5.4-cents-per-gallon exemption from the excise tax on neat ethanol fuels to 3.5 cents per gallon.

Effective Date

The bill would be effective on January 1, 1994.

i. Repeal exclusion from income for interest on bonds used to finance certain electric-generating facilities

Present Law

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of the State and local governmental units (sec. 103).

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties where much of the benefit of the tax-exempt interest rate flows directly to these private parties. However, interest on private activity bonds is not taxable if (1) the financed activity is specified in the Code and (2) at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private activity bonds) for the interest on their bonds to be excluded from gross income.

Description of Proposal

Section 302 of H.R. 2026 would provide that, notwithstanding any other provision in the Code, interest paid on bonds issued to provide facilities for the generation of electricity from specified energy sources would be included in the gross income of the recipient. Accordingly, this interest would be subject to Federal income tax. Facilities subject to this proposal would be those where electricity is generated using nuclear power, coal, crude oil, or any petroleum product.

Effective Date

The bill would be effective for bonds issued after the date of enactment.

j. Repeal tax-exempt status of electric cooperatives

Present Law

Tax-exempt status of certain electric cooperatives

Mutual or cooperative electric companies ("electric cooperatives") are exempt from Federal income tax if 85 percent or more of their income consists of amounts collected from members for the sole purpose of meeting losses and expenses (sec. 501(c)(12)(A)). In applying this 85-percent test, certain income received by an electric cooperative is disregarded, including certain pole rental income, and income from the prepayment of certain loans made by the Rural Electricification Administration (sec. 501(c)(12)(B)).

Tax-exempt organizations, including electric cooperatives, generally are subject to the unrelated business income tax (UBIT) on income from a trade or business that is not substantially related to the organization's tax-exempt purposes. Under special rules, certain investment income (e.g., interest, dividends, royalties, and certain rents) generally is exempt from UBIT.

Treatment of non-exempt cooperatives

In general.—Non-exempt cooperatives and their members are subject to special tax rules under subchapter T of the Code (secs. 1381, *et seq.*). In general, these provisions operate to treat the cooperative like a conduit, rather than as a separate taxable business enterprise. Subchapter T applies to tax-exempt farmers' cooperatives and any other corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities).

Under subchapter T, a cooperative association is allowed to exclude from its taxable income any patronage dividends paid to its members or patrons or amounts paid in redemption of a nonqualified written notice of allocation. Additionally, cooperative associations may reduce their gross income by the amount of qualified per-unit retain certificates and the amounts paid for redemptions of nonqualified per-unit retain certificates. A per-unit retain certificate is, in general, a written notice which sets forth the "per-unit retain allocation", i.e., the allocation by the cooperative association to a patron with respect to goods marketed by the cooperative association for the patron.

Members of a cooperative association who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative association markets a product for one of its members, patronage dividends attributable to the marketing are treated like additional proceeds from the sale of the product and are includible in the recipient's income. Where the cooperative association purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

In general, a patronage dividend means an amount paid to a patron (1) on the basis of the quantity or value of business done with or for such patron, (2) under an obligation of the cooperative association to pay such amount, which obligation existed before the association received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. "Such term does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons, or such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions." Sec. 1388(a).

Taxation of non-exempt electric cooperatives.—In general, the tax treatment of electric cooperatives that are not tax-exempt under section 501(c)(12) (e.g., the cooperative fails to meet the 85-percent test) is governed by a series of administrative rulings that provided tax rules applicable to cooperatives prior to enactment of Subchapter T.

Under those administrative rulings, a cooperative that purchased goods with a view towards selling those goods to members was permitted a deduction for all amounts paid to members under contract on the basis of quantity of goods handled for them. To be allowed this deduction, a cooperative association must have agreed, at the time of the original transaction with the patron, to return any net proceeds to him in proportion to patronage. Moreover, if only members were entitled to receive patronage dividends, the cooperative could not deduct (or exclude) from its gross income the portion of any distribution to members which represented profits from dealings with nonmembers. Nonoperating income, such as interest, dividends, rents and capital gains not arising from doing business with patrons, is taxable to the cooperative even when allocated to the accounts of patrons.

In determining the amount of patronage dividends which reduce the net margins of the cooperative, no distinction was drawn between patronage dividends paid in cash and such dividends in the form of stock, revolving fund certificates, or certificates of indebtedness to net amounts retained and credited to the patrons' accounts on the books of the cooperative. Courts held that cash basis patrons generally were not required to report as income amounts allocated to them by cooperatives which were not paid in cash or other property.

Description of Proposal

Section 303 of H.R. 2026 would repeal the tax-exempt status of electric cooperatives under Code section 501(c)(12).

Effective Date

This provision of the bill would apply to taxable years beginning after December 31, 1993.

k. Increase excise taxes on crude oil

Present Law

An excise tax on petroleum is imposed at the sum of 9.7 cents per barrel (the Hazardous Substances Superfund financing rate) and 5 cents per barrel (the Oil Spill Liability Trust Fund financing rate). Taxable petroleum consists of domestic or imported crude oil received at a U.S. refinery and imported refined products. The tax rates above are not applied to petroleum when the unobligated balances in the relevant trust fund reach specified levels. (The IRS has provided notice that excise tax collections for the Oil Spill Liability Trust Fund will be suspended as of July 1, 1993, as the Oil Spill Liability Trust Fund will exceed the $1 billion balance limit.)

Description of Proposal

Section 304 of H.R. 2026 would impose an excise tax of 5 cents per barrel (the "petroleum security rate") on domestic or imported crude oil received at a U.S. refinery and on imported refined products. This tax base is the same as that for the Hazardous Substances Superfund and Oil Spill Liability Trust Fund excise taxes, but there would not be a trust fund associated with receipts from this tax.

Effective Date

The bill would be effective for taxable petroleum received at a refinery or imported into the United States after December 31, 1993.

l. Limit oil and gas percentage depletion deduction to adjusted basis

Present Law

Persons who own economic interests in mines, oil and gas wells, and other natural deposits may deduct an allowance for depletion in computing taxable income. For most natural resources, taxpayers must deduct the greater of the amount measured using either the percentage or cost depletion method. Depletion deductions reduce the taxpayer's adjusted basis (but not below zero) in the depletable property.

Under cost depletion, the taxpayer recovers its basis in the property over the life of the natural resource. The cumulative allowance for cost depletion over the life of the property may not result in recovery of more than the taxpayer's basis in the property.

The percentage depletion allowance is calculated as a fixed percentage, generally ranging from 5 to 22 percent (depending upon the mineral), of the taxpayer's gross income from the mineral property (but generally not in excess of 50 percent of taxable income from the property). The percentage depletion allowance is computed without regard to the taxpayer's adjusted basis in the property. The total allowance claimed over the life of the property may, therefore, exceed the taxpayer's basis in the property. As a general rule, percentage depletion deductions claimed in excess of basis constitute an item of tax preference for the alternative minimum tax. For taxable years beginning after December 31, 1992, however, this is not the case with respect to excess percentage depletion deductions claimed on oil and gas properties.

Description of Proposal

Section 305 of H.R. 2026 would limit the deduction for percentage depletion in the case of oil and gas properties to amounts not in excess of the taxpayer's adjusted basis in the property giving rise to the deduction.

Effective Date

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

m. Repeal oil and gas working interest exception to passive activity limitation rules

Present Law

Deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income (sec. 469). Losses that are not deductible as a result of this limitation are carried forward and treated as deductions from passive activities in the following taxable year. Such losses are allowed in full when the taxpayer disposes of its entire interest in that activity to an unrelated party in a transaction in which all realized gain or loss is recognized. Similar rules apply to tax credits generated from passive activities. The provision applies to individuals, estates, trusts, and personal service corporations.

An activity generally is treated as passive if the taxpayer does not materially participate in it. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial.

A working interest in an oil or gas property is not treated as a passive activity, whether or not the taxpayer materially participates in the activities related to that property. A working interest, for purposes of this provision, means an interest with respect to an oil or gas property that is burdened with the cost of development and operation of the property and with respect to which the taxpayer's form of ownership does not limit the liability of the taxpayer.

Description of Proposal

Section 306 of H.R. 2026 would repeal the special rule under which oil and gas working interests are not treated as passive activities. Thus, a working interest in an oil or gas property with respect to which the taxpayer does not materially participate would be treated as a passive activity, and losses and credits generated by the activity would be subject to the statutory limitations discussed above.

Effective Date

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

6. Permit energy credits to offset alternative minimum tax

Present Law

As described above in Item J.5.a., nonrefundable business energy tax credits are allowed for 10 percent of the cost of qualified solar and geothermal energy property (sec. 48(a)). Also as described in item 5.a., a tax credit is allowed for the production of electricity from certain renewable resources (sec. 45). Neither of these credits may offset a taxpayer's alternative minimum tax.

Description of Proposal

The proposal would allow the business energy credits and the credit for the production of electricity from renewable sources to fully offset the alternative minimum tax.

Effective Date

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

7. Treatment of certain timber activities under the passive loss rules (H.R. 960)

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies with respect to credits from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person. Passive activities are defined to include rental activities and activities in which the taxpayer does not materially participate.

The current Treasury regulations provide rules for determining material participation under the passive loss rules. These regulations provide that, in determining whether an individual satisfies the facts and circumstances test for material participation, an individual's management activities are not taken into account unless no one else receives earned compensation for such services and no one else performs more hours of management services during the year than the taxpayer. The regulations further provide that a taxpayer is treated as not materially participating if his participation is for 100 hours or less during the year (Treas. Reg. secs. 1.469-5T(b)(2)(ii) and (iii)).

Description of Proposal

Section 3 of the bill (H.R. 960) would provide that these provisions of the regulations (Treas. Reg. secs. 1.469-5T(b)(2)(ii) and (iii)) do not apply in determining an individual taxpayer's material participation in the case of a closely-held timber activity, if the nature of the activity is such that the aggregate hours devoted to management of the activity for any year is generally less than 100 hours. A closely-held timber activity would mean a timber activity, at least 80 percent of which is owned by (1) 5 or fewer individuals, or (2) family members. A timber activity would mean the planting, cultivating, caring, cutting or preparation (other than milling) for market, of trees.

Effective Date

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

8. Exclusion from income of utility energy conservation subsidies

Present and Prior Law

Section 8217(i) of the National Energy Conservation Policy Act provided that the value of any subsidy provided by a utility to a residential customer for the purchase or installation of a residential energy conservation measure was excluded from gross income. That exclusion expired on June 30, 1989.

For amounts received after 1992, the Energy Policy Act of 1992 provides an exclusion from the gross income of a residential customer of a public utility for the value of any subsidy provided by the utility for the purchase or installation of an energy conservation measure with respect to a dwelling unit.

Description of Proposal

With respect to subsidies provided to residential customers, the exclusion from gross income provided by the National Energy Conservation Policy Act would be extended from the date on which such exclusion sunset (June 30, 1989) to the effective date of the exclusion provided by the Energy Policy Act of 1992 (January 1, 1993).

Effective Date

The proposal would be effective upon the date of enactment.

K. Housing Provisions

In general

A tax credit is allowed in annual installments over ten years for certain investments in qualifying newly constructed or substantially rehabilitated low-income residential rental housing. For most qualifying housing, the maximum credit is an amount having a present value of 70 percent of the qualified basis of the low-income housing units. For housing receiving other Federal subsidies (e.g., tax-exempt bond financing) and for the acquisition cost of existing housing that is substantially rehabilitated (e.g., costs other than rehabilitation expenditures), the maximum credit is an amount having a present value of 30 percent of qualified basis. Generally, that part of the building for which the credit is claimed must be rented to qualified low-income tenants at restricted rents for 15 years after the building is placed in service. In addition, a subsequent additional 15-year period of low-income use generally is required.

The per capita component of a State's housing credit ceiling expired after June 30, 1992, and no credit generally is allowed for projects financed by tax-exempt bonds and placed in service after June 30, 1992. (The House-passed Omnibus Budget Reconciliation Act of 1993 (H.R. 2264) would extend the program permanently, effective after June 30, 1992.)

1. Low-income housing tax credit—tenant protection

Present Law

The low-income housing tax credit provisions in the Code do not include any specific provisions concerning the grounds for denial of admission to low-income housing tax credit projects, for termination of a tenancy, or for refusal to renew the lease of a tenant.

Description of Proposal

The proposal would provide that (1) an applicant may not be denied admission to a low-income housing tax credit project because the applicant holds a voucher or certificate of eligibility under Section 8 of the Housing Act of 1937; (2) no owner of a low-income housing tax credit project shall terminate a tenancy or refuse to renew a lease of a tenant except for serious or repeated violations of the terms of the lease, for violations of law or for other good cause (same as section 225(b) of the 1990 National Affordable Housing Act); and (3) the fair housing provisions of the assisted housing titles of the United States Code shall apply to low-income housing tax credit projects.

Effective Date

The proposal would be effective on the date of enactment.

2. Low-income housing tax credit—community service areas

Present Law

Generally, the qualified basis on which the low-income housing tax credit is computed equals that percentage of the eligible basis of a qualified low-income building attributable to low-income residential rental units. Generally, the eligible basis is limited to the adjusted basis of the residential units, related facilities for use by tenants, and other facilities reasonably required by the project. Non-housing portions of a building that provides transitional housing for the homeless may be eligible for the credit if such portions are used to provide supportive services for such homeless persons.

Description of Proposal

The proposal would provide that community service buildings in projects located in qualified census tracts are included in eligible basis as functionally related and subordinate facilities if (a) the size of the facilities is commensurate with tenant needs, (b) the use of the facilities is predominantly (although not exclusively) by tenants and employees of the project owner, and (c) no more than 20 percent of the housing project's eligible basis is attributable to such facilities. Qualified census tracts are census tracts designated by the Secretary of Housing and Urban Development which are located in a metropolitan statistical area and in which 50 percent or more of the households have an income which is less than 60 percent of area median gross income.

Effective Date

The proposal would be effective for low-income housing tax credits allocated after December 31, 1992.

3. Low-income housing tax credit—rent skewing

Present Law

To qualify under the deep rent skewing exception from the general income targeting rules, at least 15 percent of the low-income units must be occupied by tenants whose incomes do not exceed 40 percent of area median income, the rents on such units must be restricted to 30 percent of the qualifying income limitation, and rents on the market rate units must be at least 200 percent of rents charged on comparable rent restricted units. For projects receiving allocations prior to 1990, rents on market rate units must be at least 300 percent of rents charged on comparable rent restricted units.

Description of Proposal

The proposal would allow an irrevocable election by the owner of a building receiving an allocation before 1990 to satisfy the 200 percent rent restriction rather than the 300 percent rent restriction.

Effective Date

The proposal would be effective on the date of enactment.

4. Low-income housing tax credit—State credit authority limitation: stacking rule

Present Law

Each State receives an annual allocation of low-income housing tax credits in an amount equal to $1.25 per resident. To qualify for the credit, a building owner generally must receive a credit allocation from the appropriate State credit authority. An exception is provided for property which is financed substantially with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation.

That portion of a State's credit authority which is unallocated in the year in which it originally arises may be carried forward and added to the State's credit authority for the subsequent calendar year. If allocations in the subsequent year exceed that year's annual per capita credit authority, but do not exhaust the sum of that year's annual credit authority plus any credit authority carried forward from the preceding year, any remaining carried-forward credit authority is allocated in the next subsequent year to the national pool. That is, credit authority carried forward from the preceding year is stacked after the current year's per capita credit authority.

Description of Proposal

For purposes of the carryforward rule, the proposal would treat credits carried forward from previous years as used before current year per capita credits. That is, the proposal would stack credit authority carried forward from the previous year before the current year's per capita credit authority.

Effective Date

The proposal would be effective for low-income housing tax credits allocated after December 31, 1992.

5. Low-income housing tax credit—projects financed by tax-exempt bonds

Present Law

The low-income housing tax credit maximum percentage is reduced from 70 percent to 30 percent on residential rental projects financed by tax-exempt bonds, unless the portion of the project financed by tax-exempt bonds is subtracted from the eligible basis. Residential rental projects receiving the 30 percent credit are not required to receive a credit allocation from the State allocating agency, if the bonds that finance the project are subject to the State private activity bond volume limitation.

Description of Proposal

The proposal would allow the 70-percent credit on projects financed by tax-exempt bonds, but would require that the entire project receive a State credit allocation.

Effective Date

The proposal would be effective for low-income housing tax credits allocated after December 31, 1992, for projects financed by tax-exempt bonds issued after December 31, 1992.

6. Low-income housing tax credit—qualified census tracts and difficult development areas

Present Law

The low-income housing tax credit maximum percentage is increased from 70 percent to 91 percent (from 30 percent to 39 percent for projects that are financed by tax-exempt bonds or Federal subsidies) for projects located in difficult development areas and qualified census tracts. Qualified census tracts are census tracts designated by the Secretary of Housing and Urban Development which are located in a metropolitan statistical area and in which 50 percent or more of the households have an income which is less than 60 percent of area median gross income. Difficult development areas are areas designated by the Secretary of Housing and Urban Development, which have high construction, land and utility costs relative to area median gross income. Qualified census tracts and difficult development areas in a metropolitan statistical area may not include more than 20 percent of the population of the metropolitan statistical area. A comparable rule applies to non-metropolitan areas.

Description of Proposal

The proposal would provide that the State allocating agency, rather than the Secretary of Housing and Urban Development, would designate qualified census tracts and difficult development areas, using the criteria of present law.

Effective Date

The proposal would be effective on the date of enactment.

7. Low-income housing tax credit—State credit authority limitation: de minimis rule

Present Law

To qualify for a share of the national pool in any calendar year, a State must use all of its otherwise available credits.

Description of Proposal

The proposal would allow a State to qualify for a share of the national pool if the State has not retained more credits than would be required to fund a 20-unit project located in that State.

Effective Date

The proposal would be effective on the date of enactment.

8. Low-income housing tax credit projects eligible for rehabilitation credit even if interior walls not preserved

Present Law

Section 47 provides a rehabilitation tax credit for certain rehabilitation expenditures with respect to certain qualified rehabilitated buildings and historic structures. To be a qualified rehabilitated building, 75 percent of the internal structural framework must be retained in place, 50 percent of the external walls must be maintained as external walls, and 75 percent of external walls must be maintained as either external or internal walls.

Description of Proposal

For residential rental projects that are financed by both the low-income housing tax credit and the rehabilitation tax credit, the proposal would provide that, notwithstanding any provisions of the law, including regulations of the Secretary of Interior, the requirement that the interior walls of the structure be preserved would be waived.

Effective Date

The proposal would be effective for property placed in service after December 31, 1992.

9. Low-income housing tax credit—rehabilitation credit income limit not to apply to certain low-income housing tax credit projects

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities. Rental activities (including rental real estate activities) are treated as passive activities. Generally, deductions attributable to passive activities, to the extent they exceed income from passive activities, may not be deducted against other income, and credits from passive activities may not reduce the taxpayer's tax liability, to the extent such credits exceed regular tax liability from passive activities. A special rule permits the deduction of up to $25,000 of losses from rental real estate activities (even though they are considered passive), if the taxpayer actively participates in them. The $25,000 amount is allowed for taxpayers with adjusted gross incomes of $100,000 or less, and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000 (determined without regard to passive activity losses).

With respect to the low-income housing tax credit and the rehabilitation credit, the special rule allowing the deduction equivalent amount of up to $25,000 of passive real estate losses is available regardless of whether the taxpayer actively participates in the rental activities. Further, the allowance of the rehabilitation credit is phased out for taxpayers with adjusted gross income between $200,000 and $250,000 (determined without regard to net passive losses, individual retirement account contributions or taxable social security benefits). Allowance of the low-income housing tax credit is not phased out at any adjusted gross income level.

Description of Proposal

The proposal would remove the adjusted gross income phaseout under the passive loss rules for property with respect to which the rehabilitation credit is allowed and with respect to which the low-income housing tax credit is also allowed.

Effective Date

The proposal would be effective for property placed in service after December 31, 1992.

10. Low-income housing tax credit—tenant occupancy requirement

Present Law

Under the general low-income tenant occupancy requirement, a residential rental project qualifies for the low-income housing tax credit only if at least: (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 50 percent or less of area median income or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income.

Description of Proposal

The proposal would extend the low-income housing tax credit to residential units occupied by tenants with incomes above 60 percent of area median income but less than 100 percent of area median income if, for each such unit, there is another unit in the residential rental project occupied by a tenant whose income is less than 40 percent of area median income. The rent restriction rules would continue to apply.

Effective Date

The proposal would be effective for low-income housing tax credits allocated after December 31, 1992.

11. Low-income housing tax credit—student housing

Present Law

A residential rental unit generally is not eligible for the low-income housing tax credit if the tenants are full-time students who are not married individuals filing joint returns. Exceptions to this rule allow the credit to be claimed on housing units occupied by persons who are enrolled in certain job training programs or by students who are receiving Aid to Families with Dependent Children (AFDC) payments.

Description of Proposal

The proposal would provide that a housing unit occupied entirely by full-time students may qualify for the credit if the full-time students are a single parent and his or her minor children and none of the tenants is a dependent of a third party. The proposal would also codify the present-law exception regarding married students filing joint returns (which continues to apply to all buildings placed in service since original enactment of the low-income housing tax credit by the Tax Reform Act of 1986).

Effective Date

The proposal would be effective on the date of enactment.

12. Low-income housing tax credit—tenant occupancy requirement: de minimis errors

Present Law

Under the general low-income tenant occupancy requirement, a residential rental project qualifies for the low-income housing tax credit only if at least: (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 50 percent or less of area median income or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income.

Description of Proposal

The proposal would authorize the Treasury Department to provide a waiver of penalties for de minimis errors in the application of the low-income tenant occupancy requirement.

Effective Date

The proposal would be effective on the date of enactment.

13. Low-income housing tax credit—tenant occupancy requirement: annual recertification

Present Law

Generally, the owner of a low-income housing tax credit project must obtain annual recertifications of tenant incomes to meet the low-income tenant occupancy requirements, regardless of whether the building is occupied entirely by low-income tenants.

Description of Proposal

The proposal would authorize the Treasury Department to grant a waiver from the annual recertification of tenant income for tenants in buildings that are occupied entirely by low-income tenants.

Effective Date

The proposal would be effective on the date of enactment.

14. Low-income housing tax credit—credits in the year of disposition

Present Law

If the owner of a low-income housing tax credit project disposes of the project prior to the end of the 15-year compliance period, no credit is allowed to the seller in the year of disposition if the seller does not post a bond to avoid recapture of the accelerated portion of the credit.

Description of Proposal

The proposal would allow the seller of the project a pro-rata share of the non-accelerated portion of the credit in the year of disposition, in cases in which the seller does not post a bond to avoid recapture of the accelerated portion of the credit.

Effective Date

The proposal would be effective on the date of enactment.

15. Low-income housing tax credit—allocation between buyer and seller (exact days/mid-month convention)

Present Law

The Code requires that the low-income housing tax credit be divided between a buyer and seller of a low-income housing tax credit project based upon the number of days during the year of disposition that the project was held by each. The Internal Revenue Service has issued guidance that requires a mid-month averaging convention.

Description of Proposal

The proposal would provide that the buyer and seller may agree to use either the exact number of days or the mid-month convention to determine the division of the credit.

Effective Date

The proposal would be effective on the date of enactment.

16. Low-income housing tax credit—treasury authority to waive requirements regarding third-party verification

Present Law

Under the general low-income tenant occupancy requirement, a residential rental project qualifies for the low-income housing tax credit only if at least: (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 50 percent or less of area median income or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income.

Description of Proposal

The proposal would allow the Secretary of the Treasury to waive any credit requirement that the owner of a low-income housing tax credit project obtain third-party verification of a tenant's (or prospective tenant's) income from combined assets if the tenant or prospective tenant indicates to the owner on a signed, sworn statement that the value of his or her combined assets does not exceed

$5,000 and if the project is occupied entirely by low-income tenants.

Effective Date

The proposal would be effective on the date of enactment.

17. Treatment of certain housing cooperatives

Present Law

Deductions by membership organizations

Under section 277(a), costs incurred by a "membership organization" attributable to furnishing services, insurance, goods or other items of value to its members are deductible in any taxable year only to the extent of any income the organization has derived from its members or transactions with members. Any excess deductions may be carried over and used to offset income from members in subsequent taxable years.

For purposes of section 277(a), the U.S. Tax Court has determined that interest earned by a housing cooperative on reserve accounts mandated by the Federal Housing Authority and the state development housing authority does not constitute "income derived ... from members or transactions with members". See *Concord Consumers Housing Cooperative v. Commissioner*, 89 T.C. 105 (1987).[60]

The Internal Revenue Service has held that section 277 applies to housing cooperatives,[61] while certain courts have held that section 277 does not apply to cooperatives subject to tax under subchapter T of the Code.[62] Subchapter T generally applies to any farmers' cooperative and any other nonexempt corporation operating on a cooperative basis, except certain mutual savings banks, mutual insurance companies, building and loan associations, and companies engaged in furnishing electric energy or providing telephone service in rural areas (sec. 1381). It is not clear whether housing cooperatives are subject to subchapter T.

Tax treatment of cooperatives

In general, a cooperative is an organization, usually a corporation, which benefits its members and patrons by selling goods to them, purchasing products from them, and returning any income in excess of costs to them. A cooperative that is subject to subchapter T may exclude any patronage dividends paid to its members and patrons from its taxable income (sec. 1382). For a cooperative other than an "exempt cooperative",[63] a patronage dividend must be determined solely by reference to the net earnings of the organization from business done with or for its patrons. The U.S. Court of Ap-

[60] The U.S. Tax Court did not address the interrelationship of sections 216, 277 and subchapter T because the record was insufficient to determine whether "petitioner [was] a 'cooperative housing corporation' within the meaning of section 216(b)(1) or that petitioner [was] 'operating on a cooperative basis' within the meaning of section 1381(a)(2)." *See* 89 T.C. at 106, n.3.

[61] See Rev. Rul. 90-36, 1990-1 C.B. 59.

[62] See *Landmark v. United States*, 25 Ct. Cl. 100, 92-1 Tax Cas. (CCH) para. 50,058 (Ct. Cl. 1992); *Farm Services Cooperative v. Commissioner*, 70 T.C. 145, 155-57, (1978), *rev'd on other grounds*, 611 F.2d 1270 (8th Cir. 1980).

[63] An "exempt cooperative" is a farmers' cooperative association described in section 521(b)(1). An exempt cooperative may allocate to its patrons and deduct, not only earnings from patronage activities, but also dividends on capital stock and earnings from nonpatronage sources (sec. 1382(c)).

peals for the Eighth Circuit has held that a nonexempt cooperative may not use patronage losses to offset nonpatronage income. See *Farm Services Cooperative v. Commissioner*, 611 F.2d 1270 (8th Cir. 1980).

Description of Proposal

Under the proposal, subchapter T would apply, and section 277 would not apply, to a "cooperative housing corporation" (as described in section 216(b)(1)).[64] The proposal would, however, adopt a rule similar to section 277 that patronage losses of a cooperative housing corporation cannot offset earnings that are not patronage earnings.

For this purpose, the proposal defines patronage earnings and losses to mean "earnings and losses ... derived from business done with or for patrons of the corporation." Moreover, the proposal specifically treats the following items as "patronage earnings": (1) interest on reasonable reserves established in connection with the corporation, including reserves required by a government agency or lender; (2) rents from laundry and parking to the extent attributable to use of the facilities by tenant-stockholders (as defined in section 216(b)(2)) and their guests; and (3) in the case of certain "limited equity cooperative housing corporations",[65] rental income attributable to housing projects operated by such corporations.

Effective Date

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

18. Treatment of rehabilitation tax credit with respect to certain central business districts under the passive loss rules

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies with respect to credits from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his or her entire interest in the passive activ-

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[64] Under section 216(b)(1), a cooperative housing corporation is a corporation (1) having only one class of stock outstanding, (2) each stockholder of which is entitled, by reason of his or her stock ownership, to occupy a residence owned or leased by the corporation, (3) which derives at least 80 percent of its gross income during the taxable year from tenant-stockholders, and (4) no stockholder of which is entitled to a distribution out of earnings and profits, except on a complete or partial liquidation of the corporation.

[65] A cooperative housing corporation would qualify for this treatment if it met the requirements under section 143(k)(9)(D)(i). Generally, a cooperative will meet those requirements if the amount paid by a tenant stockholder for stock in the corporation cannot exceed the sum of (1) the consideration paid by the first tenant-stockholder, adjusted for cost of living, (2) payments for improvements to the dwelling unit, and (3) payments to amortize corporate indebtedness arising from the acquisition or development of real property (sec. 143(k)(9)(D)(i)).

ity to an unrelated person. Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate and rental activities.

A special rule permits the deduction of up to $25,000 of losses from rental real estate activities, if the taxpayer actively participates in them. This $25,000 amount is allowed for taxpayers with adjusted gross income of $100,000 or less, and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000. For credits, an amount up to the deduction equivalent of $25,000 is allowed. In the case of the rehabilitation credit, the phaseout range is $200,000 to $250,000 of adjusted gross income.

Description of Proposal

With respect to rehabilitation credits allowed under the passive loss rule in the case of property located in certain urban central business districts that are economically depressed, the proposal would (1) repeal the adjusted gross income phaseout, and (2) increase the $25,000 deduction equivalent amount to $65,000. Thus, taxpayers with any amount of adjusted gross income could use up to $65,000 of deduction equivalent rehabilitation credits from passive activities with respect to such property to offset nonpassive income.

Effective Date

The proposal would apply to property placed in service after December 31, 1993 in taxable years ending after that date.

19. Treatment of rehabilitation tax credit under the passive loss rules (H.R. 1406)

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies with respect to credits from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his or her entire interest in the passive activity to an unrelated person. Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate and rental activities.

A special rule permits the deduction of up to $25,000 of losses from rental real estate activities, if the taxpayer actively participates in them. This $25,000 amount generally is allowed for taxpayers with adjusted gross income of $100,000 or less, and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000. For credits, an amount up to the deduction equivalent of $25,000 of credits is allowed. In the case of the rehabilitation tax credit, the phaseout range is $200,000 to $250,000 of adjusted gross income.

Description of Proposal

The bill (H.R. 1406) would repeal the adjusted gross income phaseout for rehabilitation credits under the passive loss rules. The bill would also increase the $25,000 deduction equivalent amount to $65,000 for rehabilitation credits under the passive loss rules. Thus, taxpayers with any amount of adjusted gross income could use up to $65,000 of deduction equivalent rehabilitation credits from passive activities to offset nonpassive income.

Effective Date

The bill would apply to property placed in service after December 31, 1992 in taxable years ending after that date.

20. Modification of rehabilitation tax credit limits under the passive loss rules

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies with respect to credits from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his or her entire interest in the passive activity to an unrelated person. Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate and rental activities.

A special rule permits the deduction of up to $25,000 of losses from rental real estate activities, if the taxpayer actively participates in them. This $25,000 amount generally is allowed for taxpayers with adjusted gross income of $100,000 or less, and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000. For credits, an amount up to the deduction equivalent of $25,000 of credits is allowed. In the case of the rehabilitation credit, the phaseout range is $200,000 to $250,000 of adjusted gross income.

Description of Proposal

With respect to rehabilitation tax credits allowed under the passive loss rule, the proposal would (1) increase the $25,000 deduction equivalent amount, and (2) raise the adjusted gross income phaseout range. The proposal does not specify the levels to which the deduction equivalent amount and the phaseout range would be increased.

Effective Date

The proposal would apply to property placed in service after December 31, 1993 in taxable years ending after that date.

21. Treatment of cooperatives owning only land (H.R. 1418)

Present Law

Under section 216, a tenant-stockholder of a cooperative housing corporation may deduct amounts paid to the cooperative which represent his or her proportionate share of the allowable real estate taxes and interest relating to the cooperative's land and buildings. Also, the "residence" of a tenant-stockholder is defined to include stock in a cooperative housing corporation that qualifies under section 216 if the ownership of such stock entitles the person to occupy a residence in the cooperative. *See* Temp. Treas. Reg. sec. 1.163-10T(q). Thus, a tenant-stockholder in such a cooperative may deduct interest he or she personally incurs to acquire the stock in the cooperative.

To qualify as a cooperative housing corporation under section 216, each stockholder must have the right, solely because of his or her stock ownership, to occupy a house or apartment owned or leased by the cooperative. Thus, under present law, a cooperative that only owns (or leases) the land on which the residences are located does not qualify under section 216 and the tenant-stockholders therefore may not deduct their share of the cooperative's mortgage interest and taxes or deduct interest incurred to purchase stock in that cooperative.

Description of Proposal

The bill (H.R. 1418) would amend present law so that a cooperative housing corporation under section 216 would be deemed to include corporations that only own (or lease) the land on which the residences of the tenant-stockholders are located. The bill does not apply where the residence situated on the cooperative's land is a mobile home.

Effective Date

The bill would apply to taxable years beginning after December 31, 1987.

22. Decrease recovery period to 15 years for certain low-income housing property and provide other special rules

Present Law

The depreciation deduction for residential real property is determined using a 27.5 year recovery period and the straight-line method, for regular tax purposes. For alternative minimum tax purposes, the recovery period is 40 years. No separate recovery period applies with respect to low-income housing, although a credit is provided for certain low-income housing investments (sec. 42).

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies with respect to credits from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his or her entire interest in the passive activity to an unrelated person.

A special rule permits the deduction of up to $25,000 of losses from rental real estate activities, if the taxpayer actively participates in them. This $25,000 amount generally is allowed for taxpayers with adjusted gross income of $100,000 or less, and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000. For credits, an amount up to the deduction equivalent of $25,000 of credits is allowed. In the case of the low income housing credit, the $25,000 deduction-equivalent amount applies without regard to the taxpayer's adjusted gross income.

Description of Proposal

The proposal would provide a recovery period of 15 years in determining the depreciation deduction with respect to certain low-income housing property that has been in existence for at least 10 years and that is placed in service after December 31, 1993. In addition, the $25,000 allowance under the passive loss rules would be modified by (1) eliminating the adjusted gross income phaseout for the 15-year depreciation allowed with respect to such property under the proposal, and (2) increasing the $25,000 allowance to $50,000 for the 15-year depreciation allowed with respect to such property under the proposal. Further, the recovery period under alternative minimum tax with respect to such property would be 15 years, not 40 years, so that the depreciation deduction allowed under the proposal would not be treated as a preference.

The low-income housing property qualifying for this treatment generally would be low-income housing property participating in any of four specified Housing and Urban Development Department programs.[66] At least one-half of any low-income housing project's units must house tenants with incomes at the time of initial occupancy that are less than 80 percent of area median gross income. The person placing the low-income housing property in service after December 31, 1993 would be required to expend on rehabilitation of the property at least 10 percent of the allocated purchase cost of the property. The present-law low-income housing credit would not be available with respect to property for which 15-year depreciation is allowed under the proposal.

Effective Date

The proposal would apply to qualifying low-income housing property placed in service after December 31, 1993. Rules would be pro-

[66] The four HUD programs would be the following programs established under the United States Housing Act of 1937 (section references are to that Act): (1) sec. 221(d)(3) below market interest rate; (2) sec. 221(d)(3) market rate with rental assistance; (3) sec. 236; or (4) sec. 221 (d)(4) with rental assistance. For low-income housing projects in the third or fourth programs, at least one-half the tenants must also be receiving sec. 8 rental assistance.

vided to prevent the use of like-kind exchanges or transactions involving related parties.

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L. Tax-Exempt Bond Provisions

1. The definition of private activity bonds—private benefit amount; private loan exception for housing bonds

Present Law

Under the Internal Revenue Code ("the Code") interest on State and local government bonds generally is excluded from income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of the governmental units (sec. 103). Present law also excludes the interest on certain State and local government bonds ("private activity bonds") when a governmental unit incurs debt as a conduit to provide financing for private parties, and the financed activities are specified in the Code. Tax-exempt bonds may not be issued to finance private activities not specified in the Code.

Private activity bonds are bonds (1) more than 10 percent of the proceeds of which satisfies a private business use and payment test, or (2) more than five percent ($5 million, if less) of the proceeds of which is used to finance loans to persons other than State or local governmental units. A special restriction limits to no more than five percent the amount of bond proceeds that may be used in a private business use that is unrelated to direct governmental activities also being financed with a bond issue. This five-percent restriction is known as the "unrelated and disproportionate private business use limit."

Interest on the following private activity bonds qualifies for exclusion: (1) exempt-facility bonds; (2) qualified mortgage and qualified veterans' mortgage bonds; (3) qualified small-issue bonds; (4) qualified student loan bonds; (5) qualified redevelopment bonds; and (6) qualified 501(c)(3) bonds.

Description of Proposals

One proposal would increase the amount of private activity that may be financed by the proceeds of a bond issue without the bonds being treated as private activity bonds. Specifically, the current-law 10-percent private business use and payment test would be increased to 25 percent.

A second proposal would provide an exception from the private loan bond rule if: (1) the bonds were issued by a unit of general government, (2) the bonds were secured by the full faith and credit of the issuer, (3) the proceeds of the bonds were used for loans to finance, repair, rehabilitate or construct housing, and (4) the yield on the loans were less than the yield on the bonds.

Effective Date

The proposals would be effective on date of enactment.

2. Certain cooperative research agreements

Present Law

The *General Explanation of the Tax Reform Act of 1986*[67] stated that use of bond-financed property by nongovernmental persons pursuant to such a cooperative research arrangement between State universities or other 501(c)(3) organizations and a nongovernmental person is not to be considered when determining the degree of nongovernmental use of the property, provided that the use occurs under either of the following types of arrangements.

First, a university facility may be used for corporate-sponsored research as long as any license or other use of resulting technology by the sponsoring party is permitted only on the same terms as the university would permit such use by any nonsponsoring unrelated party; that is, the sponsor must pay a competitive price for its use of the technology. Thus, the sponsoring university is not actually required to grant use of the technology to any other party; however, the sponsoring party must pay a price for the use of any resulting technology that is the same as a nonsponsoring party would pay. Further, that price must be determined at the time the technology is available for use rather than an earlier time (*e.g.*, when the research agreement is entered into).

Second, facilities used pursuant to joint industry-university cooperative research arrangements may be eligible for tax-exempt financing where, as under most such arrangements currently sponsored by the National Science Foundation—

(1) multiple, unrelated industry sponsors agree to fund university-performed basic research;

(2) the research to be performed and the manner in which it is to be performed is determined by the university;

(3) title to any patent or other product incidentally resulting from the basic research lies exclusively with the university; and

(4) sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any such research.

Description of Proposal

The proposal would provide that certain additional research and development activities at governmentally owned facilities conducted pursuant to a cooperative research agreement are not considered in determining if the private business test is violated if: (1) those activities have general applications as opposed to an application for the purpose of commercial exploitation on a preferential basis by the nongovernmental person, and (2) no nongovernmental person in the agreement is entitled to preferential use of any product of the research and development activities.

The proposal would codify the definition of research and development to include activities in the areas of health, environment, engineering, manufacturing and other technology, artificial intelligence, computer science, or other traditional sciences involving one or more of the following purposes:

[67] Joint Committee on Taxation (JCS–10–87), May 4, 1987, p. 1162.

(a) theoretical analysis, experimentation, or systematic study of phenomena or observable facts;
(b) development or testing of basic engineering techniques;
(c) extension of investigative findings or theory of a scientific or technical nature into practical applications for experimental production and testing of models, prototypes, equipment, materials, and processes; or
(d) collection, exchange and analysis of research information.

Effective Date

The proposal would be effective for bonds issued after the date of enactment of the Tax Reform Act of 1986.

3. Certain output facilities (H.R. 1938)

Present Law

The Code provides a special limit on bond financing for certain output facilities, such as electric and gas generation, transmission and related activities (but not water facilities). In the case of bonds five percent or more of the proceeds of which is to be used to finance these output projects, the maximum amount of bond-financing that may be used by nongovernmental persons on a basis other than as a member of the general public is $15 million. Thus, with respect to any such issue, the amount of bond proceeds used by such persons may not exceed the lesser of 10 percent of the proceeds or $15 million. In determining whether the $15 million limit is exceeded, all prior issues with respect to the project are counted.

Description of Proposal

The bill (H.R. 1938) would repeal the $15 million limitation.

Effective Date

The bill would be effective for bonds issued after the date of enactment.

4. Certain volunteer fire departments (H.R. 219)

Present Law

Qualified volunteer fire departments can issue tax-exempt governmental bonds (not subject to the private activity bond limitations) for the acquisition, construction, reconstruction, or improvement of: (1) firehouses (including land which is functionally related and subordinate thereto) or (2) firetrucks.

Generally, a qualified fire department is an organization which (1) is organized and operated to provide firefighting or emergency medical services for persons in an area that is not provided with any other firefighting services, and (2) is required (by written agreement) by the relevant political subdivision to furnish firefighting services in that area.

Description of Proposal

The bill (H.R. 219) would allow qualified volunteer fire departments to issue tax-exempt bonds for ambulances and other emergency response vehicles.

Effective Date

The proposal would be effective for bonds issued after the date of enactment.

5. Spaceport exempt-facility bonds

Present Law

Qualified bonds

Exempt-facility bonds are bonds 95 percent of the proceeds of which are used to finance the following: airports, docks and wharves; mass commuting facilities or high-speed intercity rail facilities; water, sewage, solid waste, or hazardous waste disposal facilities; facilities for the local furnishing of electricity or gas; local district heating or cooling facilities; and certain low-income rental housing projects.

Federal guarantee

Generally, interest on any obligation is not tax-exempt if the obligation is Federally guaranteed. An obligation is treated as Federally guaranteed if (1) the payment of the principal or interest on the obligation is guaranteed, in whole or in part, by the United States or any agency or instrumentality thereof; (2) a significant portion of the proceeds of the issue of which the obligation is a part is to be used in making loans or other investments the payments on which are guaranteed in whole or in part by the United States or any agency or instrumentality thereof; (3) a significant portion of the proceeds of the issue is to be invested, directly or indirectly, in Federally insured deposits or accounts in a financial institution; or (4) the payment of the principal or interest of the obligation is otherwise indirectly guaranteed, in whole or in part, by the United States or an agency or instrumentality thereof.

Description of Proposal

Qualified bonds

The proposal would expand the list of facilities that can be financed with exempt-facility bonds to include spaceports owned by governmental units. Generally, spaceports would be treated identically to airports for purposes of tax-exempt financing rules. The proposal would also extend tax-exempt financing to spaceport ground leases.

Spaceports would include certain facilities directly related to the operation of the spaceport located at, or in proximity to, the launch site. It would also include certain functionally related and subordinate facilities at, or adjacent to, the spaceport.

Federal guarantee

The proposal would exempt spaceport exempt-facility bonds from the Federal guarantee rules.

Effective Date

The proposal would be effective for bonds issued after the date of enactment.

6. Qualified mortgage bonds—home improvement loans; two-family housing; cooperative housing

Present Law

Qualified mortgage revenue bonds ("QMBs") are bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences located within the jurisdiction of the issuer of the bonds. Persons receiving QMB loans must satisfy principal residence, purchase price, borrower income, first-time homebuyer, and other requirements. An exception from the first-time homebuyer requirement is provided for qualified home improvement loans (not in excess of $15,000). Part or all of the interest subsidy provided by QMBs is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after it was purchased. Other rules apply in the case of QMBs used to finance cooperative housing.

The volume of QMBs that a State may issue is limited by an annual State private activity bond volume limit. Qualified governmental units may elect to exchange QMB authority for authority to issue mortgage credit certificates ("MCCs").

Authority to issue QMBs expired after June 30, 1992. (H.R. 2264, the Omnibus Budget Reconciliation Act of 1993, as passed by the House on May 27, 1993, would extend the program permanently, effective after June 30, 1992.)

Description of Proposals

The first proposal would increase the maximum size of a qualified home improvement loan under the QMB and MCC programs from $15,000 to $25,000.

The second proposal would expand authority for QMBs and MCCs to new two-family housing located in a qualified census tract or an area of chronic economic distress.

The third proposal would modify QMBs and MCCs as relating to cooperative housing by: (1) loosening the application of the current-law acquisition cost limits; (2) allowing interim rental use while units are being sold; and (3) changing how retail and parking elements in these properties are allocated.

Effective Date

The proposals relating to QMBs and MCCs would be effective for bonds issued after the date of enactment.

7. Qualified veterans' mortgage bonds

Present Law

Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to make mortgage loans to certain veterans. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984, and issuance is subject to State volume limitations based on the volume of issuance by each State before that date. The States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin. Loans financed with qualified veterans' mortgage bonds can be made only with respect to principal residences and can not be made to acquire or replace existing mortgages. Qualified veterans' mortgage bonds are not subject to the State volume limitations for private activity bonds.

Mortgage loans made with the proceeds of qualified veterans' mortgage bonds can be made only to veterans who served on active duty before 1977, and who applied for the loan before the later of (1) 30 years after the veteran leaves active service, or (2) January 31, 1985.

Description of Proposals

The first proposal would expand eligibility for qualified veterans' mortgage bonds to veterans of Desert Storm and Grenada. This proposal would not expand the program beyond the currently eligible States or otherwise modify any other applicable rules.

The second proposal (as contained in H.R. 1289) would repeal the requirements that the veterans must have served before 1977 and have applied for the loan before the later of (1) 30 years after leaving active service or (2) January 31, 1985. The proposal also would repeal the present-law volume limits for qualified veterans' mortgage loans and replace them with a $300 million State volume limitation for these bonds.

Effective Date

The proposals would apply to bonds issued after the date of enactment.

8. Qualified small-issue bonds

Present Law

Interest on small issues of private activity bonds issued by State or local governments ("qualified small-issue bonds") is excluded from gross income if certain conditions are met. First, at least 95 percent of the bond proceeds must be used to finance manufacturing facilities or certain agricultural land or equipment. Second, the bond issue must have an aggregate face amount of $1 million or less, or alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, must not exceed $10 million. Third, the bonds must be issued within one year of the date the facility to be financed is placed-in-service.

Issuance of qualified small-issue bonds, like most other private activity bonds, is subject to annual State volume limitations and to other rules.

Authority to issue qualified small-issue bonds expired after June 30, 1992. (H.R. 2264, the Omnibus Budget Reconciliation Act of 1993, as passed by the House on May 27, 1993, would extend the program permanently, effective for bonds issued after June 30, 1992.)

Description of Proposal

The proposal would extend the period for issuing any small-issue bond for which the one-year placed-in-service period expired after June 30, 1992, and before enactment of the proposed bill, until 90 days after the proposal's enactment.

Effective Date

The proposal would be effective on the date of enactment.

9. Modification of rules governing qualified 501(c)(3) bonds

Present Law

Interest on State and local government bonds generally is excluded from income if the bonds are issued to finance direct activities of these governments (sec. 103). Interest on bonds issued by these governments to finance activities of other persons, i.e., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in Code section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business (sec. 141(e)(1)(G)).

Classification of section 501(c)(3) organization bonds as private activity bonds

Before enactment of the Tax Reform Act of 1986, State and local governments and section 501(c)(3) organizations both were defined as "exempt persons," under the Code bond provisions, and their bonds generally were subject to the same requirements. As exempt persons, section 501(c)(3) organizations were not treated as "private" persons, and their bonds were not "industrial development bonds" or "private loan bonds" (the predecessor categories to current private activity bonds).

Under present law, a bond is a private activity bond if its proceeds are used in a manner violating either (1) a private business test or (2) a private loan test. The private business test is a conjunctive two-pronged test. First, the test limits private business use of governmental bonds to no more than 10 percent of the proceeds.[68] Second, no more than 10 percent of the debt service on the bonds may be derived from private business users of the proceeds.

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[68] No more than five percent of bond proceeds may be used in a private business use that is unrelated to the governmental purpose of the bond issue. The 10-percent debt service test, described below, likewise is reduced to five percent in the case of such "disproportionate" private business use.

The private loan test limits to the lesser of five percent or $5 million the amount of governmental bond proceeds that may be used to finance loans to persons other than governmental units.

Special restrictions on tax-exemption for section 501(c)(3) organization bonds

As stated above, present law treats section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(1)(3) bonds," subject to the restrictions of Code section 145. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organizations under common management or control are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations. A second restriction limits to no more than five percent the amount of the net proceeds of a bond issue that may be used to finance any activities (including all costs of issuing the bonds) other than the exempt purposes of the section 501(c)(3) organization.

Legislation enacted in 1988 imposed low-income tenant occupancy restrictions on existing residential rental property that is acquired by section 501(c)(3) organizations in tax-exempt-bond-financed transactions. These restrictions require that a minimum number of the housing units comprising the property be continuously occupied by tenants having family incomes of 50 percent (60 percent in certain cases) of area median income for periods of up to 15 years. These same low-income tenant occupancy requirements apply to for-profit developers receiving tax-exempt private activity bond financing.

Other restrictions

Several restrictions are imposed on private activity bonds generally that do not apply to bonds used to finance State and local government activities. Many of these restrictions also apply to qualified 501(c)(3) bonds.

No more than two percent of the net proceeds of a bond issue may be used to finance the costs of issuing the bonds, and these monies are not counted in determining whether the bonds satisfy the requirement that at least 95 percent of the net proceeds of each bond issue be used for the exempt activities qualifying the bonds for tax-exemption.

The weighted average maturity of a bond issue may not exceed 120 percent of the average economic life of the property financed with the proceeds.

A public hearing must be held and an elected public official must approve the bonds before they are issued (or the bonds must be approved by voter referendum). If property financed with private activity bonds is converted to a use not qualifying for tax-exempt financing, certain loan interest penalties are imposed.

Description of Proposal

The proposal would change the tax-exempt bond provisions of the Code to conform generally the treatment of bonds for section

501(c)(3) organizations to that provided for bonds issued to finance direct State or local government activities. Certain restrictions, described below, that have been imposed on qualified 501(c)(3) bonds (but not on governmental bonds), and that address specialized policy concerns, would be retained.

Repeal of private activity bond classification for bonds for section 501(c)(3) organizations

The concept of an "exempt person" that existed in the bond provisions before 1986, would be reenacted. An exempt person would be defined as (a) a State or local governmental unit or (b) a section 501(c)(3) organization, when carrying out its exempt activities under Code section 501(a). Thus, bonds for section 501(c)(3) organizations would no longer be classified as private activity bonds. However, financing for unrelated business activities of such organizations would continue to be treated as a private activity for which tax-exempt financing is not authorized.

As exempt persons, section 501(c)(3) organizations would be subject to the same limits as State and local governments on using their bond proceeds to finance private business activities or to make private loans. Thus, no more than ten percent of the bond proceeds[69] could be used in a business use of a person other than an exempt person if the Code security interest test is satisfied, and no more than five percent ($5 million if less) could be used to make loans to such "nonexempt" persons.

Repeal of most additional special restrictions on section 501(c)(3) organization bonds

Present Code section 145, which establishes additional restrictions on qualified 501(c)(3) bonds, would be repealed, along with the restriction on bond-financed costs of issuance for section 501(c)(3) organization bonds (sec. 147(h)). This eliminates the $150-million-per-organization limit on nonhospital bonds for section 501(c)(3) organizations.

Retention of certain specialized requirements for section 501(c)(3) organization bonds

As stated above, the proposal would retain certain specialized restrictions on bonds for section 501(c)(3) organizations. First, the proposal would retain the requirement that existing residential rental property acquired by a section 501(c)(3) organization in a tax-exempt-bond-financed transaction satisfy the same low-income tenant requirements as similar housing financing for-profit developers. Second, the proposal would retain the present-law maturity limitations applicable to bonds for section 501(c)(3) organizations, and the public approval requirements applicable generally to private activity bonds. Third, the proposal would continue to apply the penalties on changes in use of tax-exempt-bond-financed section 501(c)(3) organization property to a use not qualified for such financing.

[69] This limit would be reduced to five percent in the case of disproportionate private use as under the present-law governmental bond disproportionate private use limit.

Finally, the proposal would make no amendments, other than technical conforming amendments, to the tax-exempt arbitrage restrictions, the alternative minimum tax-exempt bond preference, or the provisions generally disallowing interest paid by banks on monies used to acquire or carry tax-exempt bonds.

Effective Date

The proposal would apply to bonds issued after December 31, 1993.

10. State private activity bond volume limitation

Present Law

Generally, the annual private activity bond volume limitation for each State is the greater of (1) $50 for every individual who is a resident of a State or (2) $150 million. The State may elect to carry forward an unused portion of the volume limitation for an identified purpose to be used in any of the three subsequent calendar years.

Description of Proposal

The proposal would transfer the unused portions of each State's private activity bond authority to other States which have used all of their State private activity bond authority. Those States could use the transferred amounts only for environmental conservation or recycling purposes.

Effective Date

The proposal would be effective on date of enactment.

11. Arbitrage restrictions—six-month expenditure exception; State revolving funds

Present Law

Issuers of all tax-exempt bonds generally are subject to two sets of restrictions on investment of their bond proceeds.

Yield restriction requirement

In general, tax-exempt bond proceeds may not be invested at a yield materially higher than the bond yield, i.e., only limited arbitrage profits may be earned. Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds (generally prescribed in Treasury Department regulations). Additional exceptions are provided for bond proceeds invested as part of a reasonably required reserve or replacement fund and for a "minor" portion of the issue proceeds, both throughout the term of the issue.

Unlike the rebate requirement described below, the yield restriction requirement applies both to investments unrelated to the purpose of the borrowing ("nonpurpose investments") and to investments such as a loan to the ultimate borrower of the bond proceeds in the case of private activity bonds ("purpose investments").

Rebate requirement

Generally, all arbitrage profits earned on nonpurpose investments of bond proceeds during periods when such earnings are permitted (e.g., temporary periods) must be rebated to the Federal Government. Permitted arbitrage profits on purpose investments are not subject to the rebate requirement. Present law includes three principal exceptions to the rebate requirement on nonpurpose arbitrage profits.

Six-month expenditure exception

If all gross proceeds of an issue are spent for the purpose of the borrowing within six months after the bonds are issued, no rebate is required. This exception may be satisfied notwithstanding the presence of a reasonably required reserve or replacement fund if all proceeds other than those invested as part of the reserve fund are so spent and arbitrage profits on the reserve fund are rebated.

Prior to 1990 the six-month exception was not specifically available to bond issues with a reasonably required reserve or replacement fund.

24-month construction bond expenditure exception

No rebate is required for certain construction bond issues if the available construction proceeds are spent for the purpose of the borrowing at least at specified rates during the 24-month period after the bonds are issued. A construction bond issue is an issue at least 75 percent of the net proceeds of which are to be used to finance construction (as opposed to acquisition) expenses. Construction bonds eligible for this exception include all governmental bonds, qualified 501(c)(3) bonds, and private activity bonds the proceeds of which are used to finance property owned by a governmental unit.

The construction bond exception applies to bonds issued after December 19, 1989.

Small-issuer exception

Bonds other than private activity bonds issued by governmental units having general taxing powers are not subject to the rebate requirement if the governmental unit (and all of its subordinate units) issues $5 million or less in such governmental bonds during a calendar year.

Description of Proposals

The first proposal would extend the present-law six-month expenditure exception from rebate to bonds issued after the effective date of the Tax Reform Act of 1986. This exception as currently worded was prospectively enacted in 1989.

The second proposal would provide that bond proceeds would be treated as spent for purposes of the arbitrage rules when they are deposited in a State revolving fund established for a purpose created by Federal law in an amount not greater than the minimum amount required under that law.

Effective Date

The proposals would be effective on date of enactment.

12. Certain proposals relating to the Tax Reform Act of 1986

Present Law

The Tax Reform Act of 1986 ("the 1986 Act") significantly revised the tax treatment of bonds, including the institution of a private activity bond volume limitation, and created a new tax depreciation system. The 1986 Act also provided alternative treatment with respect to these revisions for certain specifically enumerated cases.

Under the 1986 Act, Stanford University was allowed to issue bonds to provide student housing and Near West Campus facilities without regard to the $150 million 501(c)(3) tax-exempt bond volume limit. Reasonable notice must be given and a public hearing must be held before private activity bonds are issued. Further issuance of the bonds must be approved after the hearing by an elected public official or elected legislative body. Alternatively, a voter referendum, held at such time and in such manner as referenda on other issues affecting government spending under applicable State and local law, may be used in place of the hearing and elected representative approval requirements with respect to any governmental unit. The hearing must be held before the approval of the bonds.

Description of Proposals

The first proposal generally would extend the availability of certain depreciation rules and bond rules relating to specific facilities if several requirements are satisfied. For a project to qualify for these rules:

(1) The Federal Government must (a) give regulatory approval before such property can be placed in service or (b) have determined that receipt of Federal funding for the project would be necessary for the project to be undertaken;

(2) Application for such Federal regulatory approval or Federal funding was filed before March 1, 1986; and

(3) Preliminary Federal regulatory approval for the project was granted by the applicable Federal agency before October 1, 1988.

Under the proposal, no depreciation tax benefits which otherwise may accrue prior to January 1, 1999 would be allowed until that time when they would be amortized over the remaining depreciable life of the asset. Also, the bond rule transition relief would not be available to bonds issued before October 1, 1998. The proposal also would clarify the description of a proposal contained in sec. 1317(6)(o) of the 1986 Act.

The second proposal would modify a 1986 Act item which relates to redevelopment bonds for the city of Kenosha, Wisconsin, and has four elements: (1) the description of the eligible project would be corrected; (2) the availability of certain depreciation rules would be extended until September 3, 1999; (3) the availability of certain bond rules would be extended until September 3, 1996; and (4) the issuance of pooled bonds under this proposal would be allowed.

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The third proposal would allow the proceeds of the bonds issued for Stanford University to be used for: (1) student housing, (2) the Near West Campus facilities, or (3) renovation, repair, construction, reconstruction, or acquisition undertaken or made as a result of an earthquake or seismic bracing. The proposal would also exempt this issue from the public hearing and approval or voter referendum requirement.

Effective Date

The proposals would be effective as if included in the 1986 Act.

13. Expand exception to pro rata disallowance of bank interest expense related to investment in tax-exempt bonds; modify application to 501(c)(3) borrowers

Present Law

Banks and other financial institutions generally are denied a deduction for the portion of their interest expense (e.g., interest paid to depositors) that is attributable to investment in tax-exempt bonds acquired after August 7, 1986. This disallowance is computed using a pro-rata formula that compares the institution's average adjusted basis in tax-exempt bonds acquired after that date with the average adjusted basis of all assets of the institution.

An exception to the pro-rata disallowance rule is permitted for governmental bonds and qualified 501(c)(3) bonds issued by or on behalf of governmental units that reasonably expect to issue no more than $10 million of such bonds during a calendar year (the "small-issuer exception").

Description of Proposals

The first proposal would expand the small-issuer exception to include issuers that reasonably expect to issue no more than $20 million (rather than $10 million) in a calendar year.

The second proposal would modify the small-issuer exception so that, regardless of the total annual issuance of the governmental unit, up to $5 million of bonds to benefit each 501(c)(3) borrower would qualify.

Effective Date

The proposals would be effective in taxable years of financial institutions ending after the date of enactment but only for bonds issued after the date of enactment.

14. Certain airport, dock and wharve facilities

Present Law

Interest on State and local government bonds generally is exempt from the regular Federal income tax. However, interest on private activity bonds is taxable, unless the private activity which the bonds are issued to finance are specifically identified in the Code. Private activity bonds are bonds for which more than a specified minimum amount of the proceeds are used in a trade or business of an entity other than a State or local government or are used to make loans to nongovernmental entities. Most tax-exempt private activity bonds are subject to annual, per capita State volume limitations.

Tax-exempt private activity bonds may be issued to finance certain governmentally-owned airport, dock and wharve facilities. Unlike most other tax-exempt private activity bonds, however, these bonds are not subject to the annual State private activity bonds volume limitations. Airport, dock and wharve facilities financed with these bonds are limited to airports, docks, wharves, and related warehouses and infrastructure at an airport, dock or wharve.

Description of Proposal

The proposal would expand the property eligible for tax-exempt bond financing as an airport, dock or wharve facility in two respects. First, the definitions of port facility would be expanded to include all transportation facilities (including railroad track and other facilities) used for transport of cargo or passengers, at least 80 percent of which is destined for (or departing from) a currently qualified airport, dock or wharve facility.

Second, the requirement that all tax-exempt bond financed airport, dock, or wharve facilities be governmentally owned would be waived.

The proposal would not alter the present-law rule exempting private activity bonds for airport, dock and wharve facilities from the State private activity bond volume limitations.

Effective Date

The proposal would be effective for bonds issued after December 31, 1993.

M. Compliance Provisions

1. Accounting for charges by real estate reporting persons for costs of complying with reporting requirements of section 6045

Present Law

It is unlawful for any real estate reporting person to charge separately any customer for complying with the information reporting requirements with respect to real estate transactions (sec. 6045(e)(3)).

Description of Proposal

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

Effective Date

The proposal would be effective for real estate transactions closing after the date of enactment.

2. Direct deposit of tax refunds

Present Law

Under section 6402, the Internal Revenue Service (IRS) must refund to a taxpayer the amount by which any overpayment of tax (including interest thereon) exceeds any Federal tax liability owed by the taxpayer. In general, the IRS currently pays taxpayer refunds by check. The IRS, however, allows taxpayers entitled to a tax refund of $1 million or more to request, on Form 8302, a wire transfer of their refund to their bank accounts. (See I.R.S. Announcement 85-14 (January 28, 1985).)) Also, taxpayers who file their tax returns electronically generally may elect to have their refunds directly deposited into their checking or savings account in a financial institution. (See Rev. Proc. 93-8, 1993-2 I.R.B. 13 (January 11, 1993).))

Description of Proposal

The proposal would allow all taxpayers to request that their tax refunds be directly deposited by electronic funds transfer into their checking or savings account in a financial institution.

Effective Date

The proposal would apply to refunds issued on or after January 1, 1994.

N. Excise Tax Provisions

1. Harbor Maintenance Trust Fund expenditures

Present Law

Harbor maintenance excise tax

An excise tax ("harbor tax") is imposed on the use of U.S. harbors (ports) (sec. 4461). The tax is 0.125 percent of the value of commercial cargo loaded or unloaded at U.S. ports. The tax does not apply to cargo donated for overseas use and for cargo (other than cargo destined for a foreign country) shipped between the U.S. mainland and Alaska (except for crude oil), Hawaii, and/or a U.S. possession, as well as cargo shipped between Alaska (except for crude oil), Hawaii, and/or a U.S. possession. The tax also applies to ship passenger fares.

Harbor Maintenance Trust Fund expenditures

Under present law (sec. 9505(c)), amounts in the Harbor Maintenance Trust Fund ("Harbor Trust Fund") are available, as provided by appropriation Acts, for making expenditures:

(1) under section 210(a) of the Water Resources Development Act of 1986 (Corps of Engineers costs for dredging and maintaining harbors at U.S. ports);

(2) for payments of rebates of certain St. Lawrence Seaway tolls or charges; and

(3) for payment of expenses incurred by the Department of the Treasury in administering the harbor tax (but not more than $5 million per fiscal year) for periods during which no Customs processing fee applies under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("1985 Act").

The Customs processing fee currently is in effect through September 30, 1995.[70] Thus, since the Customs processing fee is in effect under the 1985 Act, the Trust Fund is not currently permitted to be used for Treasury (Customs) expenses for administering the harbor maintenance excise tax.[71]

a. Suspend harbor maintenance excise tax when the Harbor Maintenance Trust Fund exceeds a specified balance

Description of Proposal

The proposal would suspend collection of the harbor tax when the unobligated balance of the Harbor Trust Fund exceeds an unspecified threshold. Collection of the harbor tax would be resumed once the Harbor Trust Fund balance fell below the threshold.

Effective Date

The proposal would be effective on the date of enactment.

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[70] H.R. 2264 (sec. 13602 of the Omnibus Budget Reconciliation Act of 1993), as passed by the House on May 27, 1993, would extend the current Customs processing fee for three years, through September 30, 1998.

[71] H.R. 2264 (sec. 14412), as passed by the House on May 27, 1993, would remove the current restriction on Trust Fund expenditures for Treasury administrative expenses relating to the harbor tax (retaining the $5 million limit).

b. Use of Harbor Maintenance Trust Fund for certain NOAA expenditures (H.R. 2094)

Description of Proposal

The bill (H.R. 2094) would establish a new Marine Navigation Safety Account ("Marine Safety Account") within the Harbor Trust Fund. Amounts in the Marine Safety Account would be available, as provided in appropriations Acts, to carry out the programs and activities of the National Oceanic and Atmospheric Administration (NOAA) of the Department of Commerce related to commercial marine navigation under section 210(c) of the Water Resources Development Act of 1986 (as added by the bill).

Under the bill, monies in the Marine Safety Account would be available to support, either directly or by contract, the nautical charting and marine navigational safety programs and such other activities of NOAA related to commercial marine navigation as the Secretary of Commerce determines, including: (1) nautical charting programs; (2) marine tides and circulation programs; (3) charting survey ship support; and (4) marine weather services applicable to commercial navigation safety in U.S. waters. Funds in the Marine Safety Account are to be used only for the purposes of enabling, modernizing, enhancing, or expanding the capabilities of NOAA to conduct the programs referred to above. No portion of the Marine Safety Account's funds may be used to offset funds made available through appropriations to NOAA's Operations, Research, and Facilities Account.

After enactment of the bill, the Secretary of the Treasury would transfer monies from the existing Harbor Trust Fund to the Marine Safety Account in the amount equal to 8 percent of the revenues credited to the Harbor Trust Fund during calendar years 1991 and 1992. Thereafter, the Secretary would transfer to the Marine Safety Account 8 percent of the taxes received from the harbor tax after December 31, 1992.

Effective Date

The bill would be effective on the date of enactment.

2. Phaseout of special alcohol occupational excise taxes

Present Law

Under present law, annual occupational excise taxes are imposed on alcohol producers and dealers (liquors, wines and beer) as follows:

Alcohol occupation	Annual tax (per premise)
Producers (secs. 5081, 5091)	[1]($1,000)
Wholesale dealers (sec. 5111)	500
Retail dealers (sec. 5121)	250
Nonbeverage use of distilled spirits (sec. 5131)	500

Alcohol occupation	Annual tax (per premise)
Industrial use of distilled spirits (sec. 5276)	250

[1] ($500 for businesses with less than $500,000 gross receipts in previous year).

These annual taxes are imposed on a July 1-June 30 taxable period.

Description of Proposal

The proposal would phase out the alcohol occupational taxes by one-half on July 1, 1994, and would repeal the taxes on July 1, 1995.

Effective Date

The proposal would be effective on July 1, 1994.

3. Exemption from retail excise tax for truck equipment used to mix explosive chemicals (H.R. 1929)

Present Law

An excise tax is imposed on retail sales of truck chassis and truck bodies suitable for use in a vehicle with a gross vehicle weight over 33,000 pounds. The excise tax equals 12 percent of the retail sales price of heavy trucks subject to the tax. Exceptions are provided for certain equipment such as concrete mixers, trash containers, and certain farm equipment. This tax is scheduled to expire for sales made after September 30, 1999.

Description of Proposal

The bill (H.R. 1929) would provide an exemption from the 12-percent retail excise tax for truck equipment used to mix explosive chemicals. This exemption would apply to equipment (e.g., mixing units) used to process, prepare, or load explosive products, and also to equipment used to transport components of the explosive products. The gross vehicle weight of the truck (for purposes of determining whether the truck is subject to the retail sales tax) would be determined inclusive of the exempt equipment.

Effective Date

The bill would be effective for retail sales of explosive handling equipment made after December 31, 1983.

4. Limit on transfers of motorboat fuels tax revenues to the Boat Safety Account

Present Law

Under present law, amounts attributable to the revenues from the Highway Trust Fund tax rate on motorboat fuels (gasoline and special motor fuels) are transferred to the Boat Safety Account of the Aquatic Resources Trust Fund through September 30, 1997 (i.e., 11.5 cents per gallon). No more than $70 million per fiscal year may be transferred to the Boat Safety Account. Also, no amounts are to be transferred to the Boat Safety Account if the Secretary of the Treasury determines that the account balance reaches $70 million. Amounts in excess of the $70 million limits are transferred to the Sport Fish Restoration Account of the Aquatic Resources Trust Fund, to be used for State sport fish restoration projects.[72]

Amounts in the Boat Safety Account are appropriated annually and are divided one-half for State boating safety programs and one-half for the Coast Guard's boating safety program. States are allowed up to three years to spend the amounts so allocated (Title 46 U.S.C.).

Description of Proposal

The proposal would provide that amounts previously appropriated from the Boat Safety Account, but not distributed, are not to be included when calculating whether the Boat Safety Account exceeds the $70 million balance limit in the Account.

Effective Date

The proposal would be effective on the date of enactment.

5. Consolidate the tax on aviation gasoline at one point of collection

Present Law

In general, noncommercial aviation gasoline is subject to a tax of 15.1 cents per gallon: 14.1 cents per gallon when the fuel is removed from a refinery (or, if later, a terminal) and 1.0 cent per gallon when sold at retail. These revenues are transferred to the Airport and Airway Trust Fund (through December 31, 1995).

Description of Proposal

The 15.1-cents-per-gallon tax on aviation gasoline would be imposed when the fuel is removed from a refinery (or, if later, a terminal).

Effective Date

The proposal would be effective for fuel removed on or after January 1, 1994.

6. Wine spirits—permit use of whey, tomatoes and other agricultural products

Present Law

Under present law, a credit is allowed against the excise tax generally imposed on distilled spirits (i.e., $13.50 per proof gallon) based on the wine content of distilled spirits (sec. 5010). For purposes of this credit, the term "wine" means wine on which tax would be imposed by paragraph (1), (2), or (3) of section 5041(b) but for its removal to bonded premises, and does not include any sub-

[72] Also, up to $1 million of any such excess of motorboat fuels tax revenues is to be transferred to the Land and Water Conservation Fund.

or during either of the immediately preceding two calendar years.[77] If the Indian unemployment rate on the applicable Indian reservation exceeds 150 percent but does not exceed 300 percent of the national average unemployment rate at any time during the relevant calendar years, then only half of the otherwise allowable credit could be claimed (i.e., the credit rates would be 7.5 percent and 5 percent). If the Indian unemployment rate on the applicable Indian reservation does not exceed 150 percent of the national average unemployment rate at any time during the relevant calendar years, then no credit would be allowed.

For purposes of the credit, "reservation personal property" would be defined as property: (1) for which a depreciation deduction is allowable under section 168 of the Code; (2) which is not nonresidential real property, residential rental property, or any other real property with a class life of more than 12.5 years; (3) which is used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation; and (4) which is not used or located outside the Indian reservation on any regular basis.

In addition, "new reservation construction property" would be defined as property: (1) which is nonresidential real property, residential rental property, or any other real property with a class life of more than 12.5 years for which a depreciation deduction is allowable under section 168 of the Code; (2) which is located in an Indian reservation; (3) which is used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation;[78] and (4) which is originally placed in service by the taxpayer.

Further, "reservation infrastructure investment" would be defined as property: (1) for which a depreciation deduction is allowable under section 168 of the Code (whether real or personal property); (2) which benefits the tribal infrastructure; (3) which is available to the general public; and (4) which is placed in service in connection with the taxpayer's active conduct of a trade or business within an Indian reservation. The term "reservation infrastructure investment" would include otherwise qualifying property that is used or located outside an Indian reservation only if the purpose of the property is to connect to existing tribal infrastructure in the reservation (including, but not limited to, roads, power lines, water systems, railroad spurs, and communications facilities).

Notwithstanding the above definitions, property would not qualify for the Indian reservation credit if the property is acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer (within the meaning of section 465(b)(3)(C) of the Code). In addition, property would not qualify for the credit if the property (or any portion thereof) is placed in service for purposes

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[77] A special rule would apply to qualifying property that has (or is a component of a project that has) an estimated construction period of more than two years or a cost of more than $1 million. With respect to such property, the relevant unemployment rate would be the rate during the calendar year in which the taxpayer enters into a binding agreement to make a qualified investment (or, if earlier, the first calendar year in which the taxpayer has expended at least 10 percent of the qualified investment) or during the immediately preceding calendar year.

[78] The active conduct of a trade or business for purposes of the Indian reservation credit would include the rental to others of real property located in an Indian reservation. In addition, the credit for new reservation construction property would be allowed with respect to otherwise qualifying property that is used to furnish lodging.

of conducting or housing certain gaming activities.[79] Finally, property would not qualify for the Indian reservation credit if the energy credit or the rehabilitation credit is allowed with respect to the property.

In the case of reservation personal property and new reservation construction property, the qualified investment for purposes of determining the amount of the credit would be the taxpayer's basis in the property. In the case of reservation infrastructure investment, the qualified investment for purposes of determining the amount of the credit would be the amount expended by the taxpayer for the acquisition or construction of the property. The at-risk rules of section 49 of the Code also would apply in determining the amount of the qualified investment for purposes of the Indian reservation credit.

The basis of new reservation construction property would be reduced by the full amount of the credit allowed with respect to the property. The basis of reservation personal property and reservation infrastructure investment would be reduced by only 50 percent of the credit allowed with respect to the property. The Indian reservation credit would be recaptured (i.e., the amount of tax due would be increased) if, before the end of the applicable recovery period with respect to the property, the property is disposed of by the taxpayer, or, in the case of reservation personal property, is removed from the Indian reservation, converted, or otherwise ceases to be reservation personal property with respect to the taxpayer.

Indian employment tax credit

A credit against income tax liability also would be allowed to employers for certain wages and health insurance costs paid or incurred by the employer with respect to certain employees. In general, the amount of the credit allowed an employer for any taxable year would equal 10 percent[80] of the sum of (1) the wages paid or incurred by the employer for services performed by an employee while the employee is a qualified employee ("qualified wages");[81] and (2) the amount paid or incurred by the employer for health insurance (other than health insurance provided pursuant to a salary reduction arrangement) to the extent that such amount is attributable to coverage provided to an employee while the employee is a qualified employee ("qualified employee health insurance costs").

The amount of the credit allowed an employer for any taxable year, however, would be limited to an amount equal to the credit rate multiplied by the excess (if any) of (1) the sum of the qualified wages and qualified health insurance costs paid or incurred by the employer during the taxable year with respect to employees whose wages (which are paid or incurred by the employer) for such taxable year do not exceed the amount determined at an annual rate of $30,000 (as adjusted for inflation for years beginning after 1992),

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[79] The limitation would apply to class I, II, or III gaming as defined in section 4 of the Indian Regulatory Act (25 U.S.C. 2703), as in effect on the date of enactment of the bill.

[80] If, for the entire taxable year of the employer, at least 85 percent of the employees of the employer are enrolled members of an Indian tribe or spouses of enrolled members of an Indian tribe, then the amount of the credit for such taxable year would be determined by using a 30-percent rate rather than the 10-percent rate.

[81] Wages would not be eligible for the credit if attributable to services rendered by an employee during the first year he or she begins work for the employer if any portion of such wages is taken into account in determining the targeted jobs tax credit (TJTC) under section 51.

over (2) the sum of the qualified wages and qualified health insurance costs paid or incurred by the employer (or any predecessor) during the 1992 calendar year with respect to employees whose wages (which are paid or incurred by the employer or any predecessor) for such taxable year do not exceed the amount determined at an annual rate of $30,000.[82] For purposes of this limitation, all employees of a controlled group of corporations (or partnerships or proprietorships under common control) would be treated as employed by a single employer.

In general, an individual would be a qualified employee of an employer for any period only if: (1) the individual is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe;[83] (2) substantially all of the services performed during such period by the employee for such employer are preformed within an Indian reservation; (3) the principal place of abode of the employee while performing such services is on or near the Indian reservation within which the services are performed; and (4) the employee began work for such employer on or after January 1, 1994.

An employee would not be treated as a qualified employee after the date that is seven years after the day on which the employee first began work for the employer. In addition, an employee would not be treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during such taxable year (whether or not for services rendered within the Indian reservation) exceeds an amount determined at an annual rate of $30,000 (as adjusted for inflation for years beginning after 1992). Further, an employee would be treated as a qualified employee for a taxable year of the employer only if more than 50 percent of the wages paid or incurred by the employer to such employee during such taxable year are for services performed in a trade or business of the employer.

A qualified employee would not include certain relatives or dependents of the employer (described under present-law section 51(i)(1)) or, if the employer is a corporation, certain relatives of a person who owns more than 50 percent of the stock of the corporation. In addition, a qualified employee would not include any person who owns more than five percent of the stock of the employer (or if the employer is not a corporation, more than five percent of the capital or profits interests in the employer). Finally, a qualified employee would not include any individual if the services performed by the individual for the employer involve certain gaming

[82] In the case of a short taxable year, the qualified wages and the qualified health insurance costs paid or incurred by the employer would be annualized and the limitation for such taxable year would equal the otherwise applicable limitation determined using such annualized amounts multiplied by a fraction, the numerator of which is the number of days in the taxable year and the denominator of which is 365.

[83] For this purpose, an Indian tribe would be defined as any Indian tribe, band, nation, pueblo, or other organized group or community, including any Alaska Native village, or regional or village corporation, as defined in, or established pursuant to, the Alaska Native Claims Settlement Act (43 U.S.C. 1601 et. seq.), as in effect on the date of enactment of the bill, which is recognized as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

activities or are performed in a building housing such gaming activities.[84]

The Indian employment credit would be allowed with respect to full-time and part-time employees. However, if an employee is terminated less than one year after the date of initial employment, the amount of credits previously claimed by the employer with respect to that employee generally would be recaptured (unless the employee voluntarily leaves, becomes disabled, or is fired due to misconduct).

An employer's deduction otherwise allowed for wages would be reduced by the amount of the credit claimed for the taxable year. In addition, the employment credit would not be refundable. Finally, the Indian employment credit would be subject to the general business credit limitations of section 38,[85] and, therefore, the credit could not be used to reduce tentative minimum tax.

Effective Date

The Indian reservation credit would apply to property placed in service after December 31, 1993, and the Indian employment credit would apply to wages paid or incurred after December 31, 1993.

2. Alaska Native Corporations standing with respect to sale of losses

Present Law

Alaska Native Corporations established under the Alaska Native Claims Settlement Act (43 U.S.C. secs. 1601 et seq) and their consolidated return groups (Native Corporations) were permitted, from 1984 to 1988, to file consolidated returns with other corporations under rules more liberal than those generally applicable to other taxpayers. In particular, the provisions of the Tax Reform Act of 1984, which narrowed the definition of affiliated group, were explicitly made inapplicable to Native Corporations. In addition, the Tax Reform Act of 1986 clarified that generally no provision or principle of law may be applied to deny the benefit or use of losses or credits of a Native Corporation by its consolidated group. These provisions were repealed by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).

While these provisions were in effect, they permitted Native Corporations to sell their net operating losses and other tax benefits (NOLs) to unrelated corporations and their consolidated return groups ("Buyers"). Typically, the Buyer assigned (or otherwise made available) income of the Buyer to a "profit subsidiary" that was a member of the Native Corporation's consolidated return group under the applicable liberal affiliation rules. In some cases, a profitable operating corporation might itself become the "profit subsidiary" member of the Native Corporation group in order to utilize the Native Corporation's NOLs. The Buyer would compensate the Native Corporation for the use of such NOLs under the

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[84] The limitation would apply to class I, II, or III gaming as defined in section 4 of the Indian Regulatory Act (25 U.S.C. 2703), as in effect on the date of enactment of the bill.

[85] No portion of the unused business credit for any taxable year that is attributable to the Indian employment credit could be carried back to a taxable year ending before the date of enactment of the bill.

terms of a consolidated return tax sharing agreement and in accordance with the parties' agreements regarding payments for such losses.

The Internal Revenue Service (IRS) is now examining these loss sale transactions and has in some cases contested the amount of NOLs claimed as offsetting income of the profit subsidiary in the Native Corporation's return. The IRS has taken the position that any income assigned or otherwise transferred in excess of the amount of allowable NOLs sold "springs back" to the Buyer rather than being excess income of the Native Corporation. As a result, when the IRS asserts that the NOLs of a Native Corporation are not sufficient to offset the income of a profit subsidiary, the Native Corporation would not have any regular income tax liability and therefore may lack standing to litigate the validity of its NOLs.

Under provisions adopted in TAMRA, Native Corporations have certain specified procedural rights if the IRS proposes an adjustment to the tax liability of a Buyer based on the disallowance of Native Corporation NOLs. Thus, the IRS must notify a Native Corporation of the proposed adjustment to the tax liability of the Buyer. The Native Corporation also has certain specified rights to participate in administrative proceedings, and to file an amicus brief in any proceeding in a Federal court or in the United States Tax Court. Failure by the IRS to comply with these rights does not invalidate any tax adjustments made against the Buyer.

Description of Proposal

Election

Under the proposal, a Native Corporation and one or more of its Buyers could jointly and irrevocably elect to have the income of the profit subsidiary included on the consolidated tax return of the Native Corporation solely for purposes of the issuance of a statutory notice of deficiency. The Native Corporation would thus have standing to pursue the matter in Tax Court or to file a claim for refund and pursue that claim. The election would be available separately for each Buyer from each Native Corporation. Any Buyer that so elects must, however, elect for all Native Corporation transactions with the particular Native Corporation for all open taxable years.

As in H.R. 11 (102nd Cong.), the election would have to be made within 120 days after the date of enactment of the provision, and would have to meet certain specified conditions.

Any tax with respect to an NOL sale would be determined at the rate applicable to the Buyer for the taxable year of the Buyer for which the NOL sale occurred (as if the income assigned from the NOL sale had been reported by the Buyer), and the Buyer and profit subsidiary would be responsible for the payment of such tax, together with any interest, addition to tax, penalty, or other amount attributable to the income of the profit subsidiary.

A Buyer that elects under the provision would have certain participatory rights with respect to consideration of the tax consequences of an NOL sale (including the right to submit a written statement to the IRS regarding the proposed adjustment and to meet with the IRS at the same time as the Native Corporation), and the right to file an amicus brief in any judicial proceeding commenced by the Native Corporation with respect to such tax consequences. Any failure by the IRS to grant these rights would not affect the validity of the determination by the IRS of any adjustment of tax liability.

Any final determination related to the Native Corporation's NOL sales, whether by administrative settlement or final judicial decision, including any amount of tax, addition to tax, interest, penalty, or similar amount, would be binding upon the Native Corporation, the Buyer, and the IRS. However, such determination would not be binding on the IRS with respect to any non-electing Buyer.

The IRS may continue to deal with a non-electing Buyer as it would with any other taxpayer, including administrative settlement or litigation of any contested amounts.

Underpayment rate

For any underpayment resulting from a case in which an election has been made under this provision, the underpayment rate under section 6621 for tax determined under the elective procedure would be increased by one half of one percentage point. Thus, the rate under section 6621(a)(2)(B) would be the Federal Short-term rate plus 3.5 percentage points; and the rate under section 6621(c) would be the Federal Short-term rate plus 5.5 percentage points.

The application of the additional interest rate under this provision by reason of an election would not operate to suspend in any way the application of the special interest rate under section 6621(c).

Effective Date

The proposal would be effective for Native Corporations whose statute of limitations for the period of assessment related to sales under section 1804(e)(4) of the Tax Reform Act of 1986 has not expired. Those Native Corporations for which the statute of limitations expires within 120 days after the enactment of the provision would be given the right to extend such statute by agreement with the IRS to a date not less than 120 days after the date of enactment of the provision, in order to permit the making of an election. The election would be effective for all years of an electing Buyer for which the statute of limitations for assessment with respect to the Native Corporation transaction has not closed.

3. Tax credit for contributions to certain research consortia

Present Law

The research and experimentation tax credit ("research tax credit") provides a credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceed its base amount for that year. The credit expired after June 30, 1992.[86]

The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average

[86] H.R. 2264 (Omnibus Budget Reconciliation Act of 1993), passed by the House of on May 27, 1993, would permanently extend the research tax credit.

amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (such as "start-up" firms) are assigned a fixed-base percentage of three percent.

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

Qualified research expenditures eligible for the credit consist of: (1) "in-house" expenses of the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. The credit is not available for expenditures attributable to research that is conducted outside the United States. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

The 20-percent research tax credit also applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain scientific research organizations) *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.

Deductions for expenditures allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[87]

Description of Proposal

In general

Under the proposal, taxpayers who make qualifying contributions to a qualified cooperative research consortium ("research consortium") would be eligible for an income tax credit of up to 20 percent of the amount of such contributions made during the taxable year. For purposes of the proposal, a research consortium eligible to receive qualifying contributions would be an organization that (1) is registered under the National Cooperative Research Act of 1984, but only if such registration has been published (and is in effect) of the last day of the organization's taxable year with or within which the taxpayer's taxable year ends, and (2) has (a) at least five contributors, with no single member contributing more than 50 percent of total nongovernmental support, and no three members contributing more than 80 percent of total nongovernmental support, or (b) only three or four contributors, all engaged in the same trade or business, with no single member contributing more than

[87] Taxpayers may alternatively elect to claim a reduced research credit amount in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

50 percent of total nongovernmental support, and no two members contributing more than 85 percent of total nongovernmental support.

Computation of credit

The amount of qualified contributions of a taxpayer eligible for the credit would be limited, depending on the funding sources for each particular recipient research consortium (referred to as the "private source funding ratio"). The applicable private source funding ratio would equal the sum of (1) 50 percent of the research consortium's private source funding ratio (i.e., the ratio that its private, nongovernmental funding bears to its total gross receipts) for the first preceding taxable year, (2) 30 percent of the consortium's private source funding ratio for the second preceding year, plus (3) 20 percent of the consortium's private source funding ratio for the third preceding taxable year. Thus, if a research consortium received its funding entirely from private, nongovernmental sources, then the full amount of contributions to that consortium would be eligible for the 20-percent credit.

A research consortium would be required to report to its contributors and the IRS the consortium's private source funding ratio for the taxable year.

Qualified contributions

Contributions that would qualify for the credit would include cash payments as well as noncash contributions (including services provided by a taxpayer's employee, taken into account at their cost or such other basis determined under regulations), provided that such payments or noncash contributions are used by the consortium for "qualified research" as defined under present-law section 41. The cost of services provided by a taxpayer's employees could include overhead properly allocable to such services.[88] However, the amount of non-cash property or services contributed that is eligible for the credit could not exceed the amount of cash contributions made by the taxpayer to the consortium during the taxable year.

The proposal further provides that contributions by a taxpayer to a research cooperative eligible for the credit could not exceed one-third of the consortium's total nongovernmental support for the consortium's taxable year with or within which the taxpayer's taxable year ends. Moreover, if a research consortium receives nongovernmental contributions from only four members, then the qualified contributions of each member would be reduced by 20 percent. If a research consortium receives nongovernmental contributions from only three members, then the qualified contributions of each member would be reduced by 40 percent.

Contributions to a research consortium that are attributable to qualified research to be conducted after the close of the taxable year would be treated as paid or incurred during the period which the qualified research is conducted. Amounts qualifying for the credit under the proposal would not be taken into account in com-

[88] However, contributions representing overhead allocated to services performed by a taxpayer's employees could not exceed 25 percent of the salary and benefit amounts allocated to such services.

puting any credit the taxpayer may claim under the present-law section 41 research credit provisions.

Effective Date

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

4. Enhanced deduction for contributions of computer equipment to arts institutions

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.[89] However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose (sec. 170(e)(1)(B)(i)).[90]

Special rules in the Code provide augmented deductions for certain corporate contributions of inventory property for the care of the ill, the needy, or infants (sec. 170(e)(3)) and certain corporate contributions of scientific equipment constructed by the taxpayer, provided the original use of such donated equipment is by the donee for research or research training in the United States in physical or biological sciences (sec. 170(e)(4)). Under these special rules, the amount of the augmented deduction available to a corporation making a qualified contribution is equal to its basis in the donated property plus one-half of the amount ordinary income that would have been realized if the property had been sold (the sum not to exceed twice the basis).

Description of Proposal

The proposal would expand section 170(e)(4), so that an augmented deduction would be available for corporate contributions of scientific equipment used for research or research training in the United States for design research.

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[89] The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). Corporations are entitled to claim a deduction for charitable contributions, generally limited to 10 percent of their taxable income (computed without regard to the contribution) for the taxable year.

[90] For purposes of computing alternative minimum taxable income (AMTI), the deduction for charitable contributions of capital gain property is disallowed to the extent that the fair market value of the property exceeds its adjusted basis (sec. 57(a)(6)). In addition, for taxable years beginning after 1989, the AMTI of a corporation is increased by 75 percent of the amount by which adjusted current earnings (ACE) exceeds AMTI (calculated before this adjustment). ACE generally is computed pursuant to the rules that a corporation uses to determine its earnings and profits (sec. 56(g)).

Effective Date

The proposal would be effective for contributions made after December 31, 1993.

5. Extend the exception for debt-financed investments in real property to certain private foundations

Present Law

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

An exception to the rule treating income from debt-financed property as UBTI is available to pension trusts, educational institutions and certain title holding companies (collectively referred to as "qualified organizations") that make debt-financed investments in real property (sec. 514(c)(9)(A)). Under this exception income from investments in real property is not treated as income from debt-financed property. The exception is conditioned, however, on certain restrictions (described in sec. 514(c)(9)(B)) being satisfied.

Description of Proposal

The proposal would add certain private foundations to the list of qualified organizations that are eligible for the real property exception from the debt-financed property rules. A private foundation would be treated as a qualified organization if (1) at any time, more than half of the foundation's total assets acquired by gift or devise consisted of improved and unimproved real property; (2) vacant real estate acquired by gift or devise exceeded 10 percent of the value of all assets held by the foundation at the time that the debt was incurred; and (3) no member of the organization's governing body was a disqualified person (as defined in sec. 4946) other than by virtue of being a "foundation manager" for the period that the debt was outstanding.

Effective Date

The proposal would be effective for debt incurred after the date of enactment.

6. Treatment under the passive loss rules of closely-held C corporations engaged in equipment leasing

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies with respect to credits from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his or her entire interest in the passive activity to an unrelated person. Passive activities are defined to include (1) activities in which the taxpayer does not materially participate, and (2) rental activities (regardless of the taxpayer's level of participation).

The passive loss rules apply to individuals, estates and trusts, and personal service corporations. A special rule limits the use of passive activity losses and credits against portfolio income in the case of a closely held C corporation.

Description of Proposal

The proposal would provide that an equipment leasing activity of a closely held C corporation or affiliated group of corporations is not a rental activity under the passive loss rules if certain requirements are met. These requirements would be that (1) the corporation or group has at least five full-time employees substantially all of whose services are directly related to the equipment leasing activities of the corporation or group, and (2) the corporation or group has at least $5 million in gross receipts from equipment leasing activities for the taxable year. An equipment leasing activity would mean the leasing of equipment that is section 1245 property (generally, depreciable property), and the buying, selling and servicing of such equipment. Thus, under the proposal, the corporation's material participation would determine whether the equipment leasing activity is subject to limitation as a passive activity under the passive loss rules.

Effective Date

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

7. Treatment under the at-risk rules of real property acquired by foreclosure

Present Law

The at-risk rules provide that a taxpayer's deductible losses from an activity for any taxable year are limited to the amount the taxpayer has placed at risk (i.e., the amount the taxpayer could actually lose) in the activity (sec. 465). The initial amount at risk is generally the sum of (1) the taxpayer's cash contributions to the activity; (2) the adjusted basis of other property contributed to the activity; and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged as security for repayment property not used in the activity. This amount is generally increased each year by the taxpayer's share of income and is decreased by the taxpayer's share of losses and withdrawals from the activity. The at-risk rules apply to individuals and certain closely held corporations.

A special rule applicable to the holding of real property provides that qualified nonrecourse financing is treated as an amount at risk (sec. 465(b)(6)). Qualified nonrecourse financing generally includes financing that is secured by real property used in the activity and that is loaned by a Federal, State or local government or instrumentality thereof or guaranteed by a Federal, State or local government, or is borrowed by the taxpayer from a qualified person (e.g., not the seller), with respect to the activity of holding real property (other than mineral property).

Description of Proposal

The proposal would provide that financing secured by real property, that would otherwise satisfy the requirements of qualified nonrecourse financing (i.e., would be treated as an amount at risk), would not fail to be treated as qualified nonrecourse financing because such financing is provided by the seller of such property, provided that (1) such person acquired the real property by foreclosure or by instrument in lieu of foreclosure, and (2) the buyer is at risk (without regard to this provision) for at least 10 percent of the purchase price. Present-law requirements that the terms of the financing be commercially reasonable and on substantially the same terms as loans involving unrelated persons would apply under the proposal.

Effective Date

The proposal would be effective with respect to financing provided after December 31, 1993, in taxable years ending after that date.

8. Repeal limitation on farm losses under the alternative minimum tax

Present Law

Present law provides that, in computing alternative minimum taxable income, no loss of a taxpayer other than a corporation for the taxable year from any tax shelter farm activity is allowed; rather, the loss is carried forward and treated as a deduction from the activity in the next year (sec. 58(a)). A tax shelter farm activity is a farming syndicate (within the meaning of sec. 464(c)) or any other activity consisting of farming that is treated as a passive activity under the passive loss rules (sec. 469). A farming syndicate is a non-corporate enterprise engaged in the trade or business of farming, if (1) interests in the enterprise have been offered for sale in an offering required to be registered with Federal or State securities authorities, or (2) more than 35 percent of the losses during any period are allocated to limited partners or limited entrepreneurs.

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies with respect to credits from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his or her entire interest in the passive activity to an unrelated person. Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate and rental activities.

Description of Proposal

The proposal would repeal the rule of section 58(a) that, in computing alternative minimum taxable income, no loss of a taxpayer other than a corporation for the taxable year from any tax shelter farm activity is allowed. The present-law passive loss rules would continue to apply to passive activities that are farm activities.

Effective Date

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

9. Extend "placed-in-service" date for project under section 204(a)(1)(E) of the Tax Reform Act of 1986

Present Law

The Tax Reform Act of 1986 (the "1986 Act") generally repealed the investment tax credit for property placed in service after 1985 and reduced the benefits and the availability of accelerated tax depreciation for property placed in service after 1986. The 1986 Act provided certain exceptions to these changes.

Section 204(a)(1)(E) of the 1986 Act applied one such exception for a project that met the following criteria: (1) a State or an agency, instrumentality, or political subdivision thereof approved the filing of a general project plan on June 18, 1981, and on October 4, 1984, a State or an agency, instrumentality, or political subdivision thereof confirmed such plan; (2) the project plan as confirmed on October 4, 1984, included construction or renovation of office buildings, a hotel, a trade mart, theaters, and a subway complex; and (3) significant segments of such project were the subject of one or more conditional designations granted by a State or an agency, instrumentality, or political subdivision thereof to one or more developers before January 1, 1985.

This rule was to apply with respect to a property only to the extent that a building on such property site was identified as part of the project plan before September 26, 1985, and only to the extent that the size of the building on such property site was not substantially increased by reason of a modification to the project plan with respect to such property on or after such date.

In addition, this rule was not to apply for depreciation purposes unless the property was placed in service by an applicable date. In the case of property with a class life of at least 7 years but less than 20 years, the applicable date was January 1, 1989. In the case of property with a class life of 20 years or more, the applicable date was January 1, 1998 (for this project). Similar placed-in-service requirements applied to certain rules applicable to the repeal of the investment tax credit.

Description of Proposal

The proposal would waive the placed-in-service requirements for the project described in section 204(a)(1)(E) of the 1986 Act, so long as at least $250 million had been incurred or committed to the project as of April 15, 1993.

Effective Date

The proposal would be effective upon the date of enactment.

10. Modify application of accumulated earnings tax

Present law

An accumulated earnings tax is imposed on a corporation that is formed or availed of for the purpose of avoiding the income tax with respect to shareholders by permitting earnings and profits to accumulate instead of being distributed. Where applicable, the tax is imposed at a rate of 28 percent of accumulated taxable income.[91]

The fact that a corporation is a mere holding or investment company is prima facie evidence that such corporation was formed or availed of for the purpose of avoiding the income tax with respect to shareholders. In the case of other corporations, an accumulation of earnings and profits beyond the reasonable needs of the business establishes a rebuttable presumption of a tax avoidance purpose.

The term "accumulated taxable income" (ATI) subject to the tax is defined to mean regular taxable income, with certain adjustments, reduced by a deduction for dividends paid and an accumulated earnings credit. One of the adjustments made to regular taxable income in computing ATI is to deny the dividends received deduction. (Under present law, a corporation that receives dividends from another corporation is generally entitled to deduct at least 70 percent of the dividend in computing its own taxable income. A larger deduction is allowed if the recipient corporation owns 20 percent or more of the stock of the dividend paying corporation).

Since the Deficit Reduction Act of 1984, the Internal Revenue Code has provided that the application of the accumulated earnings tax to a corporation shall be determined without regard to the number of shareholders of the corporation (sec. 532(c)). That Act also eliminated certain schemes used by widely-held investment companies to avoid the accumulated earnings tax.

Prior to the 1984 Act changes, there was some controversy regarding the application of the accumulated earnings tax to widely-held corporations. The Internal Revenue Service asserted that the tax could be imposed on widely-held corporations, even those not controlled by a few shareholders or groups of shareholders. The issue had not been resolved definitively by the courts. See *Golconda Mining Corp.* v. *Commissioner,* 507 F.2d 594 (9th Cir. 1974). But see *Trico Products Corp.* v. *Commissioner,* 137 F.2d 424 (2d

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[91] The rate would be 39.6 percent under H.R. 2264 (Omnibus Budget Reconciliation Act of 1993), as passed by the House on May 27, 1993, in accordance with the higher individual income tax rates under that bill.

Cir. 1943); *Trico Products Corp.* v. *McGowan*, 169 F.2d 343 (2d Cir. 1948); and Rev. Rul. 75–305, 1975–2 C.B. 228.

In a recent case involving tax years both before and after the 1984 Act, a district court assumed for purposes of its decision on the pleadings (a motion for summary judgment) that the tax could apply to publicly-held corporations, although the court explicitly refused to rule on that question. The court, however, refused to apply the tax in the particular manner the IRS had asserted, even assuming the tax could otherwise apply. *Network Systems Corporation* v. *United States*, — F.Supp. — (D. Minn. 1993).

Description of Proposal

One proposal (H.R. 663) would repeal the provision of the Internal Revenue Code that states that the application of the accumulated earnings tax shall be determined without regard to the number of shareholders.

An alternative proposal would apply the provision that states that the application of the accumulated earnings tax shall be determined without regard to the number of shareholders only to those corporations that receive 50 percent or more of their income from securities subject to the seventy percent dividends received deduction.

Effective Date

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

11. Definition of start-up companies under research credit

Present Law

The research and experimentation tax credit ("research tax credit") provides a credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceed its base amount for that year. The credit expired after June 30, 1992.[92]

The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (such as "start-up" firms) are assigned a fixed-base percentage of three percent.

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

Qualified research expenditures eligible for the credit consist of: (1) "in-house" expenses of the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer

[92] The Omnibus Budget Reconciliation Act of 1993 (H.R. 2264), passed by the House of Representatives on May 27, 1993 would permanently extend the research tax credit.

use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. The credit is not available for expenditures attributable to research that is conducted outside the United States. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

The 20-percent research tax credit also applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain scientific research organizations) *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.

Deductions for expenditures allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.[93]

Description of Proposal

Under the proposal, if the first taxable year for a taxpayer in which it had both gross receipts and qualified research expenditures began after 1983, then the taxpayer would be treated as a start-up firm with a fixed-base percentage of three percent.

Effective Date

The proposal would be effective for taxable years beginning after June 30, 1992.

12. "The Environmental Remediation Tax Credit Act of 1993" (H.R. 2340)

Present Law

Tax credits

Present law does not provide for tax credits for investments in environmental remediation. Nonrefundable 10-percent income tax credits are allowed for investments in qualifying solar energy property and geothermal property (the "business energy tax credits").

The business energy credit is a component of the general business credit. The general business credit may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of: (1) 25 percent of net regular tax liability above $25,000; or (2) the tentative minimum tax. Any unused general business credit generally may be carried back to the three previous taxable years and carried forward to the subsequent 15 taxable years.

Tax-exempt bonds

State and local governments may issue tax-exempt bonds to finance governmental activities, but may issue tax-exempt private

[93] Taxpayers may alternatively elect to claim a reduced research credit amount in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

activity bonds only for specified purposes. Among the specified purposes are qualified exempt facilities including facilities for the furnishing of water, sewage facilities, solid waste disposal facilities, qualified hazardous waste facilities, and environmental enhancements of hydro-electric generating facilities.

Description of Proposal

The bill (H.R. 2340) would provide a 25-percent credit for the costs incurred by the taxpayer for environmental remediation with respect to any qualified contaminated site which is owned by the taxpayer and which costs are incurred by the taxpayer pursuant to an environmental remediation plan for such site which was approved by the Administrator of the Environmental Protection Agency (EPA). In addition, the bill would create a new class of private activity bonds, "qualified contaminated site remediation bonds."

Tax credits

The bill would provide that the Secretary of Housing and Urban Development designate four large cities and 20 medium-sized cities[94] for participation in the environmental remediation credit program. In addition, the Secretary of Agriculture would designate five States for participation in the environmental remediation credit program. To be eligible for designation, a city or State must submit an application to the appropriate Secretary including an environmental credit remediation program that provides procedures for assessment of contaminated sites located within the city or State, a credit allocation plan, and provision for non-Federal contributions to the environmental remediation. The credit allocation plan must select sites for remediation based upon: (1) the condition of the contaminated site and its likelihood for redevelopment in the absence of the environmental remediation credit program; (2) contaminated sites that have not been in productive use for at least one year prior to participation in the program; (3) likelihood of redevelopment of the site for industrial or commercial use; and (4) the likelihood that remediation and redevelopment are completed within a reasonable period of time.

The appropriate Secretary is to select eligible cities or States based upon: (1) the comparative degree of economic deterioration among cities (or States) of the same category, as measured by the city's manufacturing job loss between 1970 and 1990; (2) the strength and quality of the established local commitment to remediate contaminated sites; and (3) the percentage of the total Comprehensive Environmental Response, and Liability Information System sites which are located in such city or State. The first criterion is to carry twice the weight of the latter two in the selection procedure.

For each calendar year after 1993, the bill would establish an overall credit limitation of $75 million, to be allocated $25 million among the designated large cities, $25 million among the designated medium-sized cities, and $25 million among the designated States. Jurisdictions receiving a portion of the overall credit limita-

[94] A large city is any city with a population of at least 1,000,000 and a medium-sized city is any city with a population of at least 250,000 but less than 1,000,000.

tion for any calendar year may make allocations only during the calendar year or the calendar year subsequent to the receipt of such portion.

No credits may be claimed unless the Administrator of the EPA certifies the environmental remediation plan for such site has been completed. Upon such certification, taxpayers may claim credits allocated to them ratably over the five taxable years beginning with the taxable year in which the plan was certified as complete.[95]

Environmental remediation includes removal or remediation activity including soil and ground water remediation, restoration of natural, historic, or cultural resources, health assessments or studies, environmental audits, remediation of off-site contamination caused by activity on the site, and other costs reasonably required by reason of the environmental conditions on the site.[96]

The credit would be part of the general business credit. The basis of any qualified contaminated site shall be reduced by the amount of the any credit claimed with respect to the site.

Tax-exempt bonds

The bill would create a new class of private-activity bonds, "qualified contaminated site remediation bonds." A qualified contaminated site remediation bond is any bond at least 95 percent of the proceeds of which are used to finance the acquisition of a qualified contaminated site[97] or the costs of environmental remediation. The bonds would be subject to the annual State private activity bond volume limitation. Only persons eligible to claim the environmental remediation credit could use the proceeds of qualified contaminated site remediation bonds.

Effective Date

The bill would be effective upon the date of enactment.

13. Social Security tax status of distributors of bakery products

Present Law

Under section 3121(d)(3)(A) of the Internal Revenue Code, bakery distributors are treated as employees for Social Security payroll tax purposes if:

(1) their services are part of a continuing relationship with the person for whom they are performed;

(2) the distributor's service contract contemplates that he or she will perform substantially all of the services personally; and

(3) the distributor does not have a substantial investment in facilities used in the performance of services, excluding facilities used for transportation.

This provision also applies to distributors of meat, vegetable, fruit, and beverage (other than milk) products, as well as to distributors of laundry and dry cleaning services.

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[95] Provision is made for situations where unforeseen circumstances increase the cost of completing the remediation plan in excess of 200 percent of the estimated completion cost.

[96] Such additional expenses would include demolition of existing contaminated structures, site security, and permit fees.

[97] Acquisition costs include the costs of acquiring land.

Description of Proposal

The proposal would delete distributors of bakery products from the list of product and service distributors treated as employees for Social Security payroll tax purposes under section 3121(d)(3)(A).

Effective Date

The proposal would be effective for taxable years beginning after 1993.

14. Application of common paymaster rules to certain agency accounts at State universities

Present Law

In general, FICA taxes are payable with respect to employee remuneration which does not exceed the contribution base specified in the law. If an employee works for more than one employer during the year, FICA taxes are payable for each employer up to the contribution base.

Section 3121(s) of the Internal Revenue Code provides an exception known as the "common paymaster" rule. If two or more related corporations concurrently employ the same individual and compensate that individual through a common paymaster which is one of the corporations, each corporation is considered to have paid the individual only the amounts actually disbursed by it to the individual and is not considered to have paid as remuneration amounts actually disbursed to the individual by the other corporation. Thus, the remuneration is subject to FICA taxation only up to the contribution base for the total remuneration.

Section 125 of the Social Security Amendments of 1983 provides that a State university that employs health care professionals as faculty members at a medical school and a tax-exempt faculty practice plan that employs faculty members of the medical school are deemed to be related corporations for purposes of the common paymaster rule, provided that 30 percent or more of the employees of the plan are concurrently employed by the medical school. Remuneration that is disbursed by the faculty practice plan to an individual employed by both the plan and the university which, when added to remuneration actually disbursed by the university, exceeds the contribution base, will be deemed to have been actually disbursed by the university as a common paymaster and not to have been disbursed by the faculty practice plan.

Description of Proposal

The proposal would establish a common paymaster rule in cases where a State university provides remuneration to certain health care professionals as members of its faculty and an agency account at such university also provides remuneration to such health care professionals.

Effective Date

The proposal would be effective for remuneration paid after December 31, 1993.

15. Issuance of certificates to the Social Security Trust Funds (H.R. 931)

Present Law

In general, section 201(d) of the Social Security Act requires the Secretary of the Treasury to invest annual surpluses of the Social Security Trust Funds in interest bearing obligations of the U.S. government. Under current Treasury practice, these holdings are recorded as entries on a ledger. No certificates are issued to the Trust Funds evidencing these obligations.

Description of Proposal

The bill (H.R. 931) would require that each obligation purchased by the Social Security Trust Funds be accompanied by a certificate evidencing its principal amount, date of maturity, and interest rate. Each such certificate would also state on its face that—

> The obligation is incontestable in the hands of the trust fund to which it is issued, the obligation is supported by the full faith and credit of the U.S. Government, and the U.S. Government is pledged to the payment of the obligation with respect to both principal and interest.

No later than 60 days after enactment, the Secretary would be required to issue similar certificates for all outstanding Social Security Trust Fund obligations.

Effective Date

The bill would be effective upon enactment.

16. Exempt non-affiliated religiously oriented schools from coverage under the Federal Unemployment Tax Act (FUTA)

Present Law

The Federal Unemployment Tax Act (FUTA) requires States to cover under their unemployment compensation laws certain nonprofit organizations designated in FUTA. FUTA provides for two exemptions from this coverage: services performed in the employ of (1) a church or convention or association of churches, or (2) an organization which is operated primarily for religious purposes and which is operated, supervised, controlled, or principally supported by a church or convention or association of churches.

Individuals who are in the employ of entities with a religious orientation which are not affiliated with a particular church, or convention or association of churches, are not exempt.

Description of Proposal

The proposal would amend the Internal Revenue Code of 1986 to exempt from FUTA taxation a tax-exempt, nonprofit "elementary or secondary school which is operated primarily for religious purposes . . . ."

Effective Date

The proposal would apply to services performed after December 31, 1993.

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