[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET PROPOSAL (RELEASED ON MARCH 19, 1996)

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the revenue provisions contained in the President's fiscal year 1997 budget proposal, as submitted to the Congress on March 19, 1996.[2] The order of the descriptions in this pamphlet generally follows the order in the Administration's statutory language. The Appendix shows the staff estimates of the President's revenue proposals for fiscal years 1997–2006.

This document does not include a description of certain user fees (other than IRS user fees) contained in the President's fiscal year 1997 budget proposal that may or may not be considered to be in the jurisdiction of the tax committees.[3]

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1997 Budget Proposal (Released on March 19, 1996)* (JCS–2–96), March 27, 1996.

[2] See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals*, March 1996. Also, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1997: Analytical Perspectives*, H. Doc. 104–162/Vol. 3, pp. 35–48.

[3] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1997: Analytical Perspectives*, H. Doc. 104–162/Vol. 3, pp. 53–57.

I. MIDDLE CLASS TAX RELIEF

A. Families with Children

1. Credit for families with young children

Present Law

In general

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

Mathematical or clerical errors

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

Description of Proposal

The proposal would provide taxpayers with a nonrefundable tax credit of $300 for each qualifying child under the age of 13 (as of the close of the calendar year in which the taxpayer's taxable year begins) for taxable years 1996, 1997 and 1998. The amount of the credit would be increased to $500 for each qualifying child for taxable years beginning after December 31, 1998. This provision is subject to the "tax cut sunset" provision of the President's budget proposal. If the tax cut sunset is triggered, the credit would not apply to taxable years beginning after December 31, 2000.

The credit would be phased out ratably for taxpayers with AGI over $60,000 and would be fully phased out at AGI of $75,000. In

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

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

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

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

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995. Pursuant to the "tax cut sunset" provision of the proposal, the provision would be sunset effective December 31, 2000. Thus, the credit would not be available for taxable years beginning after December 31, 2000. However, the President has proposed that the provision be reinstated if the fiscal dividend for the year 2000 is at least $20 billion.

2. Deduction for higher education expenses

Present Law

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regu-

lations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162–5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's adjusted gross income (AGI).

Education expenses that are reimbursed by the employer are excludable from the employee's gross income as a working condition fringe benefit (sec. 132(d)) if the education qualifies as work related under section 162. A special rule allowed an employee to exclude from gross income up to $5,250 paid by his or her employer for educational assistance, regardless of whether the education maintained or improved a skill required by the employee's current position (sec. 127). That special rule for employer-provided educational assistance expired after 1994.

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[4] "Qualified higher education expenses" include tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's AGI during the year the bond is redeemed. To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. There is, however, no dollar limitation for the section 117 exclusion, provided that the scholarship funds are used to pay for tuition and required fees. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations.

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

Section 108(f) provides that gross income subject to Federal income tax does not include amounts discharged from the cancellation or discharge of certain student loans, provided that the discharge was pursuant to a provision of the loan under which the indebtedness would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers (e.g., providing health care services to a nonprofit organization). Student loans eligible for the section 108(f) exclusion include any loan to an individual to assist the individual in attending a primary, secondary, or post-secondary educational institution, but only if the loan was made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) an educational organization that originally received the funds from which the loan was made from the United States or a State, or (4) certain tax-exempt public benefit corporations whose employees have been deemed to be public employees under State law. As with section 117, there is no dollar limitation for the section 108(f) exclusion. Section 108(f) applies to loans "to assist the individual in attending an educational organization" and is not restricted (in contrast to sec. 117) to amounts used for tuition and required fees.

Currently, many States operate prepaid tuition programs, under which the State sells a contract to an individual to pay future tuition expenses of the individual (or a designated beneficiary) at a State college or university. The IRS has taken the position that beneficiaries of such prepaid tuition programs are subject to tax at the time the tuition is paid on the value of the tuition less the cost of the prepaid tuition contract (see LTR 8825027). In addition, in *Michigan v. United States*, 40 F.3d 817 (6th Cir. 1994), the Sixth Circuit held that the Michigan Education Trust, an entity created by the State of Michigan to operate a prepaid tuition program, is an agency or instrumentality of the State, and, thus, the investment income of the Trust is not subject to Federal income tax at the Trust level.

Description of Proposal

A taxpayer would be allowed an above-the-line deduction for qualified higher education expenses paid during the taxable year for the education or training of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents at an institution of higher education. The deduction would be allowed in computing a taxpayer's AGI and could be claimed regardless of whether the taxpayer itemizes deductions. In 1996, 1997, and 1998, the maximum deduction allowed per taxpayer return would be $5,000. After 1998, the maximum deduction would be increased to $10,000. The deduction would be phased out ratably for taxpayers with modified AGI between $70,000 and $90,000 ($100,000 and $120,000 for joint returns). Modified AGI would be AGI (defined without respect to this proposal) plus amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). After 1999, the income phase-out ranges would be indexed for inflation. A student would not be eligible to claim a deduction under the

proposal on his or her tax return if that student could be claimed as a dependent of another taxpayer.[5]

Pursuant to the "tax cut sunset" provision of the proposal, the provision will be sunset effective December 31, 2000. Thus, the deduction for qualified higher education expenses would not be available for taxable years beginning after December 31, 2000. However, the President has proposed that the provision be reinstated if the fiscal dividend for the year 2000 is at least $20 billion.

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

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

The term "institution of higher education" would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions must have entered into an agreement with the Department of Education to participate in the student loan program. This definition includes colleges and universities, and certain vocational and proprietary institutions.

The amount of qualified higher education expenses (prior to the application of the $5,000 or $10,000 deduction limitation) would be reduced by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, qualified higher education expenses would be reduced by scholarship or fellowship grants (received with respect to the student for the taxable year) that are excludable from gross income under section 117 and any educational assistance received as veterans' benefits.[6] Similarly, qualified higher education expenses would be reduced by proceeds from Series EE savings bonds that are excludable by the taxpayer under present-law section 135 for the taxable year. However, no reduction would

[5] If a taxpayer is married, the deduction would be available only if the taxpayer and his or her spouse file a joint return for the taxable year the deduction is claimed.

[6] For example, if during a taxable year, a taxpayer pays $8,500 for college tuition, but receives a $4,000 tax-free scholarship to cover some of those same tuition expenses, the taxpayer would be deemed to have paid $4,500 of "qualified higher education expenses" under the proposal.

be required for a gift, bequest, devise or inheritance within the meaning of section 102(a).

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

The proposal would not affect deductions claimed under any other section of the Code, except that any amount deducted under another section of the Code could not also be deducted under the proposal.

Effective Date

The proposal would be effective for qualified higher education expenses paid after December 31, 1995. Pursuant to the "tax cut sunset" provision of the proposal, the provision would be sunset effective December 31, 2000. Thus, the deduction for qualified higher education expenses would not be available for taxable years beginning after December 31, 2000. However, the President has proposed that the provision be reinstated if the fiscal dividend for the year 2000 is at least $20 billion.

B. Provisions Relating to Individual Retirement Plans

Present Law

In general

Under certain circumstances, an individual is allowed a deduction for contributions to an individual retirement account or an individual retirement annuity (an "IRA"). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. No deduction is permitted with respect to contributions made to an IRA for a taxable year after the IRA owner attains age 70½.

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

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

Nondeductible IRA contributions

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

Taxation of withdrawals

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

To discourage the use of amounts contributed to an IRA for nonretirement purposes, withdrawals from an IRA prior to age 59½, death, or disability are generally subject to an additional 10-percent income tax. The 10-percent tax is intended to recapture at least a portion of the tax benefit of the IRA. The 10-percent tax

does not apply to withdrawals that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and the taxpayer's designated beneficiary. A similar early withdrawal tax applies to withdrawals from qualified retirement plans.

Elective deferrals

Under a qualified cash or deferred arrangement, an individual can elect to have compensation paid in cash or contributed to a tax-qualified retirement plan. Amounts contributed at the election of the employee are referred to as elective deferrals. Like other qualified plan contributions, elective deferrals are not includible in income until withdrawn from the plan. Qualified cash or deferred arrangements are subject to the same rules applicable to qualified plans generally, and are also subject to additional requirements. One of these additional requirements is that the maximum amount of elective deferrals that can be made in a year by an individual is limited to $9,500 in 1996. This dollar limit is indexed for inflation in $500 increments. A similar limit applies to elective deferrals under similar arrangements (e.g., tax-sheltered annuities).

Description of Proposal

In general

In general, the proposal would (1) increase the present-law income limits (in two steps) on deductible IRA contributions and increase the income phase-out range to $20,000 (so that, for married taxpayers in 1996, 1997, and 1998, the income phase-out range would be $70,000 to $90,000 of AGI, and $80,000 to $100,000 thereafter; and for single taxpayers in 1996, 1997, and 1998, the income phase-out range would be $45,000 to $65,000 of AGI, and $50,000 to $70,000 thereafter); (2) index the $2,000 IRA contribution limit in $500 increments, and index the income limits in $5,000 increments; (3) coordinate the IRA contribution limit with the elective deferral limit; (4) create nondeductible tax-free IRAs called "Special IRAs;" and (5) provide an exception from the 10-percent early withdrawal tax for IRA distributions used for higher education expenses, first-time homebuyer expenses, extraordinary medical expenses (including long-term care expenses), and distributions to individuals who have been receiving unemployment compensation for at least 12 weeks. The proposal would also provide that IRA assets can be invested in qualified State prepaid tuition program instruments.

Deductible IRA contributions

The proposal would increase the income limits at which the maximum IRA deduction is phased out for active participants in employer-sponsored retirement plans in two steps. For married taxpayers in 1996, 1997, and 1998, the income phase-out range would be $70,000 to $90,000 of AGI, and $80,000 to $100,000 thereafter. For single taxpayers in 1996, 1997, and 1998, the income phase-out range would be $45,000 to $65,000 of AGI, and $50,000 to

$70,000 thereafter. The income thresholds would be indexed for inflation in $5,000 increments, beginning after 1999.

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

The proposal would provide that the exception to the early withdrawal tax for distributions after age 59½[7] does not apply to amounts that have been held in an IRA for less than 5 years.

Inflation adjustment for IRA contribution limit

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

Nondeductible tax-free IRAs

Under the proposal, individuals who are eligible to make deductible IRA contributions also would be eligible to make nondeductible contributions to a Special IRA. Special IRAs generally would be treated the same as IRAs, but also would be subject to special rules. The IRA deduction limit and the limit on contributions to Special IRAs would be coordinated. Thus, the maximum contribution that could be made in a year to a Special IRA would be the excess of the IRA deduction limit applicable to the individual over the amount of the individual's deductible IRA contributions. Distributions from Special IRAs would not be includible in income to the extent attributable to contributions that had been in the Special IRA for at least five years. Withdrawals of earnings from Special IRAs before five years would be subject to income tax, and also would be subject to the 10-percent tax on early withdrawals unless used for one of the special purposes described below (or a present-law exception to the tax, other than the exception for distributions after age 59½, applies).

An individual whose AGI for a year does not exceed $100,000 for married taxpayers and $70,000 for single taxpayers (both indexed beginning in 1999 in $5,000 increments) could convert an existing IRA into a Special IRA without being subject to the 10-percent tax on early withdrawals. The amount transferred from the deductible IRA to the Special IRA generally would be includible in the individual's income in the year of the transfer.[8] However, if a transfer is made before 1998, the amount to be included in the individual's income with respect to the transfer would be spread evenly over four taxable years.[9]

Special purpose withdrawals

The proposal would provide exemptions from the 10-percent early withdrawal tax for distributions from IRAs or Special IRAs used for certain special purposes. Penalty-free withdrawals would be withdrawals (1) for qualified higher education expenses, (2) for ac-

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[7] Age 59½ would be changed to age 59 under one of the proposals relating to pension simplification. See part "III. Pension Simplification Provisions," below.

[8] The amount transferred would not be included in the taxpayer's AGI for purposes of applying the income limits on IRA contributions to the taxpayer for the year of transfer.

[9] In the case of such a transfer before 1998, the amount of such transfer would also be taken into account for purposes of the 15-percent excise tax on excess distributions ratably over a four-year period.

quisition of a principal residence for a first-time homebuyer, (3) for medical expenses (including long-term care expenses) in excess of 7.5 percent of AGI, and (4) made by individuals who have been receiving unemployment compensation for at least 12 consecutive weeks.

Investment in qualified State prepaid tuition program instruments

The proposal would provide that any IRA assets can be invested in qualified State prepaid tuition program instruments, and would also modify the Code's prohibited transaction rules so that the investment in qualified State prepaid tuition program instruments is not considered a prohibited transaction. A qualified State prepaid tuition program instrument would be generally defined as an instrument issued under a State program that can be (1) converted into some percentage of the tuition and fees (which would qualify under the definition of qualified higher education expenses for purposes of special purpose withdrawals as described above) if the beneficiary under the instrument attends an institution of higher education specified in the instrument, or (2) redeemed for an amount not less than the purchase price (less any reasonable administrative fees) if the instrument is not used for tuition and fees. The designated beneficiary could be the account holder or the account holder's spouse, child, grandchild, or dependent of the account holder. To the extent the instrument is converted into tuition and fees, the account holder would be treated as receiving a distribution equal to the cost of such tuition and fees as of the time of the conversion. Further, such a deemed distribution would be treated as a special purpose withdrawal for qualified higher education expenses, and thus would not be subject to the 10 percent additional tax on early withdrawals. The tax treatment of the deemed distribution would depend on whether the instrument is held by an IRA or a Special IRA.

Effective Date

The proposal would generally be effective for taxable years beginning after December 31, 1995, and would sunset effective December 31, 2000. In the case of Special IRAs, it is intended that the rules in the proposal regarding income tax treatment of earnings and distributions continue to apply with respect to contributions made before the sunset date. Thus, earnings on such contributions would accumulate tax-free and distributions attributable to contributions that had been held for 5 years would not be includible in income, even if the distribution occurs after December 31, 2000. The President has proposed that proposal be reinstated if the fiscal dividend for the year 2000 is at least $20 billion.

II. SMALL BUSINESS TAX RELIEF

1. Increase in deduction for health insurance expenses of self-employed individuals

Present Law

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

Description of Proposal

The proposal would increase the deduction for health insurance expenses of self-employed individuals as follows: 35 percent in 1996 and 1997, 40 percent in 1998, 45 percent in 1999, and 50 percent in 2000 and thereafter (subject to the conditions of the "tax cut sunset" provision as indicated in Part VII).

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995, and would sunset effective December 31, 2000. Thus, the deduction for health insurance expenses of self-employed individuals would be reduced to 30 percent in 2001 and thereafter. However, the President has proposed that the provision be reinstated if the fiscal dividend for the year 2000 is at least $20 billion.

2. Increase in expensing for small businesses

Present Law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $17,500 of the cost of qualifying property placed in service for the taxable year (sec. 179).[10] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $17,500 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Description of Proposal

The proposal would increase the $17,500 amount allowed to be expensed under Code section 179 to $25,000 (subject to the conditions of the "tax cut sunset" provision). The increase would be phased in as follows:

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

Taxable year beginning in—	Maximum expensing
1996	$19,000
1997	20,000
1998	21,000
1999	22,000
2000	23,000
2001	24,000
2002 and thereafter	25,000

Effective Date

The proposal would be effective for property placed in service in taxable years beginning after December 31, 1995, subject to the phase-in schedule set forth above. Pursuant to the "tax cut sunset" provision of the proposal, this provision would be sunset effective for taxable years beginning after December 31, 2000. Thus, the maximum expensing allowed under section 179 would revert to $17,500 for property placed in service in taxable years beginning after December 31, 2000. However, the President has proposed that the provision be reinstated if the fiscal dividend for the year 2000 is at least $20 billion.

3. Modify estate tax provisions for closely held businesses

Present Law

In general, the estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short-term rate plus 3 percentage points). Under section 6601(j), however, a special low 4-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. All interest paid on the deferred estate tax is allowed as a deduction against either the estate tax or the estate's income tax obligation. If the deduction is taken against the estate tax, supplemental returns must be filed each year to recompute the value of the taxable estate.

To qualify for the installment payment election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. An interest in a closely held business includes: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners, or if at least 20 percent of the partnership's assets are included in determining the decedent's gross estate; or (3) stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20 percent of the value of the voting stock is included in determin-

ing the decedent's gross estate. In general, the installment payment election is available only if the estate directly owns an interest in a closely held active trade or business. Under a special rule, however, an executor may elect to look through certain non-publicly traded holding companies that own stock in a closely held active trade or business, but if the election is made, neither the five-year deferral (i.e., the provision that requires no principal payments until the fifth year) nor the special four-percent rate applies.

If the installment payment election is made, a special estate tax lien applies to any property on which tax is deferred for the installment payment period.

Description of Proposal

The proposal would increase the amount of value in a closely held business that would be eligible for the special low interest rate, from $1,000,000 to $2,500,000. Interest paid on the deferred estate tax would not be deductible for estate or income tax purposes, but the 4-percent rate would be reduced to 2 percent, and the deferred estate tax on any value of a closely held business in excess of $2,500,000 would be subject to interest at a rate equal to 45 percent of the usual rate applicable to tax underpayments.

The proposal also would expand the availability and benefits of the holding company exception to include partnerships that function as holding companies, and would clarify and expand the non-readily tradeable stock requirement to include non-publicly traded partnerships. In addition, an estate using the holding company exception (as modified by the proposal) would be able to take advantage of the five-year deferral and special 2-percent rate, thus providing the same relief to closely held businesses whether owned directly or through holding companies.

Finally, the proposal would authorize the Secretary of the Treasury to accept security arrangements in lieu of the special estate tax lien.

Effective Date

The proposal would apply to the estates of decedents dying after December 31, 1996. Estates that are deferring estate tax under current law could make a one-time election to use the lower interest rates and forgo the interest deduction.

III. PENSION SIMPLIFICATION PROVISIONS

A. Increased Access to Pension Plans

1. Establishment of National Employee Savings Trusts ("NESTs")

Present Law

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

IRAs are not subject to the same rules as qualified plans, but the amount that can be contributed in any year is significantly less. The maximum deductible IRA contribution for a year is limited to $2,000. Distributions from IRAs and employer-sponsored retirement plans are generally taxable when made. In addition, distributions prior to age 59½ generally are subject to an additional 10-percent early withdrawal tax.

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

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

ing contributions, and are subject to a special nondiscrimination test similar to the special nondiscrimination test applicable to elective deferrals.

Description of Proposal

In general

The proposal would create a simplified retirement plan for small business called the NEST. NEST plans could be adopted by employers who employed 100 or fewer employees earning at least $5,000 in compensation for the preceding year and who do not maintain another employer-sponsored retirement plan that provides for elective or employer matching contributions. Under a NEST plan, contributions on behalf of an employee would be made to an IRA. A NEST plan would not be subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements would apply. Within limits, contributions to a NEST plan would not be taxable until withdrawn.

Establishment of NEST plans

In general

A NEST plan would allow employees to make elective contributions to an IRA. Employee elective contributions could not exceed the greater of $5,000 or one half the elective deferral limit which applies to section 401(k) plans ($9,500 for 1996).

Under the proposal, the employer would be required to satisfy one of two contribution formulas. Under the nonelective contribution formula, the employer would be required to make a 3 percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation. An employer could elect a lower compensation threshold, provided such compensation threshold is applied uniformly to all eligible employees. An employer would be permitted to make discretionary nonelective contributions above the amount required under the nonelective contribution formula (or, in addition to the nonelective contribution required under the matching contribution formula described below), provided such contributions are made on a uniform basis and do not exceed 5 percent of compensation.

Under the matching contribution formula, the employer would have to make a matching contribution on behalf of each eligible employee that is equal to (1) 100 percent of the employee's elective contributions up to 3 percent of compensation, and (2) at least 50 percent (and no greater than 100 percent) of the employee's elective contributions from 3 to 5 percent of compensation. In addition to making a matching contribution, an employer complying with the matching contribution formula would be required to make a 1 percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation, although, as with the nonelective contribution formula, the employer could elect a lower compensation threshold provided it is applied uniformly to all eligible employees.

An employer would be required to elect a contribution formula prior to any year and would be required to notify eligible employees

of the formula selected before the employee election period for the year (described below).

Employers who employed 100 or fewer employees with at least $5,000 in compensation for the preceding year, and who do not currently maintain a qualified plan providing for either employee elective contributions or employer matching contributions (including a tax-sheltered annuity plan under section 403(b)), could establish NEST accounts for their employees. Under a special rule, employers would be given a 2-year grace period to maintain a NEST plan once they are no longer eligible.

Each employee of the employer who received at least $5,000 in compensation from the employer during two consecutive prior years and who is at least age 21 would have to be eligible to participate in the NEST plan. Nonresident aliens and employees covered under a collective bargaining agreement would not have to be eligible to participate in the NEST plan. Self-employed individuals could participate in a NEST plan. An employer could choose to apply less stringent eligibility requirements, provided such requirements are applied on a uniform basis.

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

A NEST account would have to prohibit the distribution of contributions made for a year (and income allocable thereto) during the 2-year period beginning on the first day of such year.

Tax treatment of NEST accounts, contributions, and distributions

Contributions to a NEST account generally would be deductible by the employer. If the employer maintains another plan, contributions made under the NEST plan would be taken into account for purposes of the limits on deductible contributions, although the contribution under the NEST plan would not by itself be subject to such deduction limits. Similarly, the contributions under the NEST plan would not be subject to the limits on contributions and benefits under section 415. However, to the extent the employer maintains another plan, the contributions would be taken into account in applying the section 415 limit to such other plan.

Contributions to a NEST account would be excludable from the employee's income. NEST accounts, like IRAs, would not be subject to tax. Distributions from a NEST account generally would be taxed under the rules applicable to IRAs. Thus, distributions would be includible in income when withdrawn and early withdrawals from a NEST account generally would be subject to the 10-percent early withdrawal tax applicable to IRAs. Tax-free trustee-to-trustee transfers could be made from a NEST account to another NEST account or to an IRA.

Administrative requirements

Each eligible employee could elect, within the 30 days of first becoming eligible to participate in the NEST plan, to participate for the year. Further, each eligible employee could elect, within the 60-day period before the beginning of any year, to participate in the NEST plan and to modify any previous elections regarding the amount of contributions. Employees would have to be allowed to

terminate participation in the NEST plan at any time during the year (i.e., to stop making elective deferrals). The plan could provide that an employee who terminates participation could not resume participation until the following year. A plan could permit (but would not be required to permit) an individual to make other changes to his or her salary reduction contribution election during the year (e.g., reduce contributions).

In the case of elective contributions, the employer would be required to make such contributions to an employee's NEST account no later than the date on which such contributions would be required to be made if such contribution were elective deferrals under a section 401(k) plan. In the case of employer nonelective or matching contributions, the employer generally would be required to make such contributions to an employee's NEST account within 45 days following the last day of the calendar quarter for which the contributions are to be made. If the employer applies a compensation threshold for nonelective contributions, a special rule would apply with respect to contributions on behalf of employees who have not yet reached such threshold for a year.

Except as provided by the Secretary, an employer would generally be permitted to suspend all NEST contributions (i.e., all employee elective, employer matching, and employer nonelective contributions) at any time during the year after notifying eligible employees in writing at least 30 days before such suspension. Only one suspension would be allowed during any year. Such suspension would apply to contributions with respect to compensation earned after the effective date of the suspension.

An employer would be permitted to designate a NEST account trustee to which distributions on behalf of eligible employees are made.[11]

Reporting requirements

Trustee requirements.—The trustee of a NEST account would be required each year to prepare, and provide to the employer maintaining the NEST plan, a summary description containing the following basic information about the plan: the name and address of the employer and the trustee; the requirements for eligibility; the benefits provided under the plan; the time and method of making salary reduction elections; and the procedures for and effects of, withdrawals (including rollovers) from the NEST account. At least once a year, the trustee would also be required to furnish an account statement to each individual maintaining a NEST account. In addition, the trustee would be required to file an annual report with the Secretary. A trustee who fails to provide any of such reports or descriptions would be subject to a penalty of $50 per day

[11] Simplified reporting requirements would apply to NEST plans under Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"). While the fiduciary provisions contained in Title I of ERISA generally would apply to a NEST plan, certain exceptions from fiduciary liability would apply where NEST plan participants are notified of their rights to transfer funds to another NEST account or IRA. Assuming such notice is provided, the employer would not be subject to fiduciary liability under Title I of ERISA resulting from either the designation of the NEST account trustee or the manner in which the assets in the NEST account are invested upon the earlier of (1) an affirmative election with respect to the initial investment of any contributions, (2) a rollover contribution (via a trustee-to-trustee transfer) to another NEST account or IRA, or (3) one year after the NEST account is established.

until such failure is corrected, unless the failure is due to reasonable cause.

Employer reports.—The employer maintaining a NEST plan would not be required to make any reports to the government. The employer would be required to notify each employee of the employee's opportunity to make salary reduction contributions under the plan as well as the contribution formula chosen by the employer immediately before the employee becomes eligible to make such election. This notice must include a copy of the summary description prepared by the trustee. An employer who fails to provide such notice would be subject to a penalty of $50 per day on which such failure continues, unless the failure is due to reasonable cause.

Definitions

For purposes of the rules relating to NEST plans other than for purposes of determining who is an eligible employer or eligible employee, compensation would be compensation required to be reported by the employer on Form W-2, plus any elective deferrals of the employee. For purposes of determining who is an eligible employer or eligible employee, compensation would be compensation required to be reported by the employer on Form W-2 regardless of any elective deferrals. In the case of a self-employed individual, compensation would be net earnings from self employment. For all purposes, compensation in excess of $150,000 in any year could not be taken into account. "Employer" would include the employer and related employers. Related employers would include trades or businesses under common control (whether incorporated or not), controlled groups of corporations, and affiliated service groups. In addition, the leased employee rules would apply.

Effective Date

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

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

Present Law

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

Description of Proposal

The proposal would allow (1) nongovernmental tax-exempt organizations and (2) Indian tribal governments, their subdivisions, agencies, and instrumentalities and any corporation at least 50 percent of which (by vote or value) is owned by an Indian tribal government, to maintain qualified cash or deferred arrangements. The proposal would retain the present-law prohibition against the maintenance of cash or deferred arrangements by State and local

governments, except to the extent it may apply to Indian tribal governments.

Effective Date

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

B. Simplified Distribution Rules

Present Law

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

Lump-sum distributions

Lump-sum distributions from qualified plans and annuities are eligible for special 5-year forward averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient first, on account of the death of the employee, second, after the employee attains age 59½ third, on account of the employee's separation from service, or fourth, in the case of self-employed individuals, on account of disability. Lump-sum treatment is not available for distributions from a tax-sheltered annuity.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59½ to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. In general, this election allows the taxpayer to pay a separate tax on the lump-sum distribution that approximates the tax that would be due if the lump-sum distribution were received in 5 equal installments. If the election is made, the taxpayer is entitled to deduct the amount of the lump-sum distribution from gross income. Only one such election on or after age 59½ may be made with respect to any employee.

Recovery of basis

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

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

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

Required distributions

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

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed beginning no later than the participant's required beginning date (sec. 401(a)(9)). The required beginning date is generally April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70½. In the case of a governmental plan or a church plan, the required beginning date is the later of first, such April 1, or second, the April 1 of the year following the year in which the participant retires.

Description of Proposal

Lump-sum distributions

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

Recovery of basis

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

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

Required distributions

The proposal would modify the rule that requires all participants in qualified plans to begin distributions by age 70½ without regard to whether the participant is still employed by the employer and generally would replace it with the rule in effect prior to the Tax Reform Act of 1986. Under the proposal, distributions generally would be required to begin by April 1 of the calendar year following the later of (1), the calendar year in which the employee attains age 70;[12] or (2), the calendar year in which the employee retires. However, in the case of a 5-percent owner of the employer, distributions would be required to begin no later than the April 1 of

[12] Another proposal (described below) would eliminate references to ½ years, and therefore would change all references to age 70½ for purposes of the minimum distribution rules to age 70.

the calendar year following the year in which the 5-percent owner attains age 70.

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

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

Effective Dates

Lump-sum distributions

The proposal would be effective for taxable years beginning after December 31, 1998.

Recovery of basis

The proposal would be effective with respect to annuity starting dates after December 31, 1996.

Required distributions

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

C. Nondiscrimination Provisions

1. Definition of highly compensated employees and family aggregation rules

Present Law

Definition of highly compensated employee

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

Family aggregation rules

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

Similar family aggregation rules apply with respect to the $150,000 (for 1996) limit on compensation that may be taken into account under a qualified plan (sec. 401(a)(17)) and for deduction purposes (sec. 404(1)). However, under such provisions, only the spouse of the employee and lineal descendants of the employee who have not attained the age 19 are taken into account.

Description of Proposal

Definition of highly compensated employee

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

Family aggregation rules

The proposal would repeal the family aggregation rules.

Effective Dates

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

2. Modification of additional participation requirements

Present Law

Under present law, a plan is not a qualified plan unless it benefits no fewer than the lesser of (1) 50 employees of the employer or (2) 40 percent of all employees of the employer (sec. 401(a)(26)).

Description of Proposal

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

Effective Date

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

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

Present Law

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

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

A plan that would otherwise fail to meet the special nondiscrimination test for qualified cash or deferred arrangements is not treated as failing such test if excess contributions (with allocable income) are distributed to the employee or, in accordance with

Treasury regulations, recharacterized as after-tax employee contributions. For purposes of this rule, in determining the amount of excess contributions and the employees to whom they are allocated, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentage beginning with those highly compensated employees with the highest actual deferral percentages. A similar rule applies to employer matching contributions.

Description of Proposal

Prior-year data

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

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

Safe harbor for cash or deferred arrangements

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

A plan would satisfy the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan either (1) satisfies a matching contribution requirement, or (2) the employer makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes elective contributions under the arrangement.

A plan would satisfy the matching contribution requirement if, under the arrangement: (1) the employer makes a nonelective contribution on behalf of each nonhighly compensated employee equal to 1 percent of compensation; (2) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective contributions up to 3 percent of compensation and (b) 50 percent of the employee's elective contributions from 3 to 5 percent of compensation; and (3) the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees.

Alternatively, if the rate of matching contribution with respect to any rate of elective contribution requirement is not equal to the percentages described in the preceding paragraph, the matching contribution requirement would be deemed to be satisfied if (1) the rate of an employer's matching contribution does not increase as an employee's rate of elective contribution increase and (2) the aggregate amount of matching contributions at such rate of elective con-

tribution at least equals the aggregate amount of matching contributions that would be made if matching contributions satisfied the above percentage requirements.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules would be required to be nonforfeitable and subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement.

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

Alternative method of satisfying special nondiscrimination test for matching contributions

The proposal would provide a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions. Under this safe harbor, a plan would be treated as meeting the special nondiscrimination test if (1) the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and (2) the plan satisfies a special limitation on matching contributions.

The limitation on matching contributions would be satisfied if: (1) the employer matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6 percent of compensation; (2) the rate of an employer's matching contribution does not increase as the rate of an employee's contributions or elective deferrals increase; and (3) the matching contribution with respect to any highly compensated employee at any rate of employee contribution or elective deferral is not greater than that with respect to an employee who is not highly compensated.

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

Distribution of excess contributions and excess aggregate contributions

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

Effective Dates

The proposals relating to use of prior-year data and the distribution of excess contributions and excess aggregate contributions

would be effective for plan years beginning after December 31, 1996. The safe harbor for qualified cash or deferred arrangements and the alternative method of satisfying the special nondiscrimination test for matching contributions would be effective for plan years beginning after December 31, 1998.

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

Present Law

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

Description of Proposal

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

Effective Date

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

5. Uniform retirement age

Present Law

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

Description of Proposal

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

Effective Date

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

D. Miscellaneous Pension Simplification

1. Plans covering self-employed individuals

Present Law

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

Description of Proposal

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

Effective Date

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

2. Elimination of special vesting rule for multiemployer plans

Present Law

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

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

Description of Proposal

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

Effective Date

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

3. Distributions under rural cooperative plans

Present Law

A qualified cash or deferred arrangement can permit withdrawals of employee elective deferrals only after the earlier of (1) the participant's separation from service, death, or disability, (2) termination of the arrangement, or (3) in the case of a profit-sharing or stock bonus plan, the attainment of age 59½ or the occurrence of a hardship of the participant. In the case of a money purchase pension plan, including a rural cooperative plan, in-service withdrawals by participants cannot occur upon attainment of age 59½ or upon hardship.

Description of Proposal

The proposal would provide that a rural cooperative plan that includes a cash or deferred arrangement may permit in-service distributions to plan participants after the attainment of age 59½ or on account of hardship.

Effective Date

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

4. Treatment of multiemployer and governmental plans under section 415

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan (sec. 415). In the case of defined benefit pension plans, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $120,000 (indexed for inflation). The dollar limit is reduced in the case of early retirement or if the employee has less than 10 years of plan participation.

Certain special rules apply to State and local governmental plans under which such plans may provide benefits greater than those permitted by the limits on benefits applicable to plans maintained by private employers.

Description of Proposal

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

(1) the 100 percent of compensation limitation on defined benefit pension plan benefits would not apply; and
(2) the early retirement reduction and the 10-year phase-in of the defined benefit pension plan dollar limit would not apply to certain disability and survivor benefits.

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

Effective Date

The proposal would apply to multiemployer plans for years beginning after December 31, 1996, and to governmental plans for years beginning after December 31, 1995.

5. Excess benefits plans of tax-exempt organizations

Present Law

Present law places limits on the amount that can be deferred annually under an unfunded deferred compensation arrangement of a tax-exempt organization (a "section 457 plan") to $7,500.

Description of Proposal

The proposal would provide that excess benefit arrangements of tax-exempt organizations are not subject to the $7,500 limit on annual deferrals under a section 457 plan. An excess benefit arrangement would be defined as a plan maintained solely to provide benefits in excess of the limits on contributions and benefits (sec. 415) applicable to qualified plans.

Effective Date

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

6. Contributions on behalf of disabled employees

Present Law

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

Description of Proposal

The proposal would provide that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined con-

tribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

Effective Date

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

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

Present Law

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

Amounts deferred under a section 457 plan may not be made available to an employee before the earlier of (1) the calendar year in which the participant attains age 70½, (2) when the participant is separated from the service with the employer, or (3) when the participant is faced with an unforeseeable emergency.

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

Description of Proposal

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

(1) The proposal would permit in-service distributions of accounts that do not exceed $3,500 under certain circumstances.

(2) The proposal would increase the number of elections that can be made with respect to the time distributions must begin under the plan.

(3) The proposal would provide for indexing (in $500 increments) of the dollar limit on deferrals.

Effective Date

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

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

Present Law

Until deferrals under a section 457 plan are made available to a plan participant, such amounts deferred, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights must remain solely the property and

rights of the employer, subject only to the claims of the employer's general creditors.

Description of Proposal

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

Effective Date

The proposal generally would be effective with respect to amounts held on or after the date of enactment. In the case of amounts deferred before the last day of the first calendar quarter beginning after the close of the first regular session of the State legislature beginning after the date of enactment, a trust would not have to be established by reason of the proposal before such last day. In the case of a State that has a 2-year legislative session, each year of such session would be deemed to be a separate regular session of the State legislature.

9. Assumptions for adjusting certain benefits of defined benefit plans for early retirement

Present Law

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

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

Description of Proposal

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

est rate to be used could not be less than the greater of 5 percent or the rate specified in the plan.

Effective Date

The proposal would be effective as if included in the Retirement Protection Act.

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

Present Law

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

Description of Proposal

Under the proposal, each tax-sheltered annuity contract, not the tax-sheltered annuity plan, would have to provide that elective deferrals made under the contract may not exceed the annual limit on elective deferrals.

Effective Date

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

11. Repeal of combined plan limit

Present Law

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

Description of Proposal

The proposal would repeal the combined plan limit.

Effective Date

The proposal repealing the combined plan limit would be effective with respect to years beginning after December 31, 1998.

12. Tax on prohibited transactions

Present Law

Present law prohibits certain transactions (prohibited transactions) between a qualified pension plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. A two-tier excise tax is imposed on prohibited transactions. The initial level tax is equal to 5 percent of

the amount involved with respect to the transaction. If the transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed.

Description of Proposal

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

Effective Date

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

13. Treatment of leased employees

Present Law

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

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

Description of Proposal

Under the proposal, the present-law "historically performed" test would be replaced with a new test under which an individual would not be considered a leased employee unless the individual's services are performed under significant direction or control by the service recipient.

Effective Date

The proposal would be effective for years beginning after December 31, 1996, except that the changes would not apply to relationships that have been previously determined by an IRS ruling not to involve leased employees.

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

Present Law

Any person who fails to file an information report with the IRS on or before the prescribed filing date is subject to penalties for

each failure. A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments.

Description of Proposal

The proposal would incorporate into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients.

Effective Date

The proposal would be effective with respect to returns and statements the due date for which is (determined without regard to extensions) after December 31, 1996.

15. Full funding limitation of multiemployer plans

Present Law

Under the Internal Revenue Code, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

Plans subject to the minimum funding rules are required to make an actuarial valuation of the plan not less frequently than annually.

Description of Proposal

The proposal would provide that the 150 percent of current liability limitation does not apply to multiemployer plans. In addition, the proposal would replace the present-law annual valuation requirement for multiemployer plans and instead would require that valuations of such plans be made at least every 3 years.

Effective Date

The proposal would apply to plan years beginning after December 31, 1996.

16. Elimination of partial termination rules for multiemployer plans

Present Law

Under present law, when a qualified retirement plan is terminated, all plan participants are required to become 100 percent vested in their accrued benefits to the extent those benefits are funded. In order to prevent an employer from evading this rule simply by amending the plan to exclude nonvested employees or by laying off nonvested employees before terminating the plan, a qualified retirement plan must also provide that, upon a "partial termination," all affected employees must become 100 percent vest-

ed in their benefits accrued to the date of the termination, to the extent the benefits are funded (sec. 411(d)(3)).

Whether a partial termination has occurred in a particular situation is generally based on the specific facts and circumstances of that situation, including the exclusion from the plan of a group of employees who have previously been covered by the plan, by reason of a plan amendment or severance by the employer. In addition, if a defined benefit plan stops or reduces future benefit accruals under the plan, a partial termination is deemed to occur if, as a result, a potential reversion of plan assets to the employer is created or increased.[13]

Description of Proposal

Under the proposal, the requirement that affected participants become 100 percent vested in their accrued benefits (to the extent funded) upon the partial termination of a qualified retirement plan would not apply with respect to multiemployer plans.

Effective Date

The proposal would be effective for partial terminations that begin after December 31, 1996.

17. Elimination of half-year requirements

Present Law

In general, distributions from qualified retirement plans and individual retirement arrangements ("IRAs") prior to age 59½ are subject to a 10 percent additional tax on early withdrawals (sec. 72(t)). In addition, under certain plans (such as a section 401(k) plan), distributions before age 59½ are generally prohibited. Present law also requires that certain minimum distributions from IRAs and qualified retirement plans must begin by the required beginning date, which is generally April 1 of the year following the year the participant reaches age 70½.

Description of Proposal

Under the proposal, for purposes of the provisions described above, all references to age 59½ would be changed to age 59, and all references to age 70½ would be changed to age 70.

Effective Date

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

18. Treatment of certain veterans' reemployment rights

Present Law

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), Pub. L. No. 103-353, 38 U.S.C. 4301, ff., which revised and restated the Federal law protecting

[13] Treas. Reg. sec. 1.411(d)-2(b).

veterans' reemployment rights, an employee who leaves a civilian job for qualified military service generally is entitled to be reemployed by the civilian employer if the individual returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued, but for the employee's absence due to the qualified military service.

USERRA generally provides that for a reemployed veteran service in the uniformed services is considered service with the employer for retirement plan benefit accrual purposes, and the employer that reemploys the returning veteran is liable for funding any resulting obligation. USERRA also provides that the reemployed veteran is entitled to any accrued benefits that are contingent on the making of, or derived from, employee contributions or elective deferrals only to the extent the reemployed veteran makes payment to the plan with respect to such contributions or deferrals. No such payment may exceed the amount the reemployed veteran would have been permitted or required to contribute had the person remained continuously employed by the employer throughout the period of uniformed service. Under USERRA, any such payment to the plan must be made during the period beginning with the date of reemployment and whose duration is three times the reemployed veteran's period of uniform service, not to exceed five years.

Under the Internal Revenue Code, overall limits are provided on contributions and benefits under certain retirement plans. For example, the maximum amount of elective deferrals that can be made by an individual into a qualified cash or deferred arrangement in any taxable year is limited to $9,500 for 1996 (sec. 402(g)). Annual additions with respect to each participant under a qualified defined contribution plan generally are limited to the lesser of $30,000 (for 1996) or 25 percent of compensation (sec 415(c)). Annual deferrals with respect to each participant under an eligible deferred compensation plan (sec. 457) generally are limited to the lesser of $7,500 or 33⅓ percent of includible compensation. There is no provision under present law that permits contributions or deferrals to exceed these and other annual limits in the case of contributions with respect to a reemployed veteran.

Other requirements for which there is no special provision for contributions with respect to a reemployed veteran include the limit on deductible contributions and the qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules.

Description of Proposal

The proposal would provide special rules in the case of certain contributions ("make-up contributions") with respect to a reemployed veteran that are required or authorized under USERRA. The proposal would apply to contributions made by an employer or employee to an individual account plan or to contributions made by an employee to a defined benefit plan that provides for employee contributions.

Under the proposal, if any make-up contribution is made by an employer or employee with respect to a reemployed veteran, then such contribution would not be subject to the generally applicable plan contribution limits (i.e., secs. 402(g), 402(h), 403(b), 408, 415, or 457) or the limit on deductible contributions (i.e., secs. 404(a) or 404(h)) as applied with respect to the year in which the contribution is made. In addition, the make-up contribution would not be taken into account in applying the plan contribution or deductible contribution limits to any other contribution made during the year. However, the amount of any make-up contribution could not exceed the aggregate amount of contributions that would have been permitted under the plan contribution and deductible contribution limits for the year to which the contribution relates had the individual continued to be employed by the employer during the period of uniformed service.

Under the proposal, a plan to which a make-up contribution is made on account of a reemployed veteran would not be treated as failing to meet the qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules (i.e., secs. 401(a)(4), 401(a)(26), 401(k)(3), 401(k)(11), 401(m), 403(b)(12), 408(k)(3), 408(k)(6), 408(p), 410(b), or 416) by reason of the making of such contribution. Consequently, for purposes of applying the requirements and tests associated with these rules, make-up contributions would not be taken into account either for the year in which they are made or for the year to which they relate.

Under the proposal, a special rule would apply in the case of make-up contributions of salary reduction, employer matching, and after-tax employee amounts. A plan that provides for elective deferrals or employee contributions would be treated as meeting the requirements of USERRA if the employer permits reemployed veterans to make additional elective deferrals or employee contributions under the plan during the period which begins on the date of reemployment and has the same length as the lesser of (1) the period of the individual's absence due to uniformed service multiplied by three or (2) five years.

The employer would be required to match any additional elective deferrals or employee contributions at the same rate that would have been required had the deferrals or contributions actually been made during the period of uniformed service. Additional elective deferrals, employer matching contributions, and employee contributions would be treated as make-up contributions for purposes of the rule exempting such contributions from qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules as described above.

The proposal would clarify that USERRA does not require (1) any earnings to be credited to an employee with respect to any contribution before such contribution is actually made or (2) any make-up allocation of any forfeiture that occurred during the period of uniformed service.

The proposal also would provide that the plan loan, plan qualification, and prohibited transaction rules will not be violated merely because a plan suspends the repayment of a plan loan during a period of uniformed service. A conforming amendment to the pro-

hibited transaction rules in the Employee Retirement Income Security Act of 1974 ("ERISA") would also be made.

The proposal also would define compensation to be used for purposes of determining make-up contributions and would conform the rules contained in the Code with certain rights of reemployed veterans contained in USERRA pertaining to employee benefit plans.

Effective Date

The proposal would be effective as of December 12, 1994, the effective date of the benefits-related provisions of USERRA.

19. Date for adoption of plan amendments

Present Law

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

Description of Proposal

The proposal would generally provide that any amendments to a plan or annuity contract required by the pension simplification proposals would not be required to be made before the end of the first plan year beginning on or after January 1, 1998. The date for amendments would be extended to the end of the first plan year beginning on or after January 1, 1999, in the case of a governmental plan.

Effective Date

The proposal would be effective on the date of enactment.

IV. EMPOWERMENT ZONES AND ENTERPRISE COMMUNITIES; "BROWNFIELDS"

1. Additional empowerment zones and enterprise communities

Present Law

In general

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas (with aggregate population for the six designated urban empowerment zones limited to 750,000) and three empowerment zones are located in rural areas.[14] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392).

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of section 179 expensing for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to $37,500 of expensing); and (3) special tax-exempt financing for certain zone facilities (described in more detail below).

The 95 enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period.

Definition of "qualified zone property"

Present-law section 1397C defines "qualified zone property" as depreciable tangible property (including buildings), provided that: (1) the property is acquired by the taxpayer (from an unrelated party) after the zone or community designation took effect; (2) the original use of the property in the zone or community commences with the taxpayer; and (3) substantially all of the use of the property is in the zone or community in the active conduct of a trade or business by the taxpayer in the zone or community. In the case of property which is substantially renovated by the taxpayer, how-

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[14] The six designated urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (New Jersey). The three designated rural empowerment zones are located in Kentucky Highlands (Clinton, Jackson, Wayne counties, Kentucky), Mid-Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Mississippi), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, Willacy counties, Texas).

ever, the property need not be acquired by the taxpayer after zone or community designation or originally used by the taxpayer within the zone or community if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed 100 percent of the taxpayer's basis in the property at the beginning of the period, or $5,000 (whichever is greater).

Definition of "enterprise zone business"

Present-law section 1397B defines the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community; (2) at least 80 percent of the total gross income is derived from the active conduct of a "qualified business" within a zone or community; (3) substantially all of the business's tangible property is used within a zone or community; (4) substantially all of the business's intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) no more than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.[15] In addition, the leasing of real property that is located within the empowerment zone or community to others is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property to others is not a qualified business unless substantially all of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone or enterprise community.

Tax-exempt financing rules

Tax-exempt private activity bonds may be issued to finance certain facilities in empowerment zones and enterprise communities. These bonds, along with most private activity bonds, are subject to an annual private activity bond State volume cap equal to $50 per resident of each State, or (if greater) $150 million per State.

Qualified enterprise zone facility bonds are bonds 95 percent or more of the net proceeds of which are used to finance (1) "qualified zone property" (as defined above) the principal user of which is an

[15] Also, a qualified business does not include certain facilities described in section 144(c)(6)(B)(e.g., massage parlor, hot tub facility, or liquor store) or certain large farms.

"enterprise zone business" (also defined above[16]), or (2) functionally related and subordinate land located in the empowerment zone or enterprise community. These bonds may only be issued while an empowerment zone or enterprise community designation is in effect.

The aggregate face amount of all qualified enterprise zone bonds for each qualified enterprise zone business may not exceed $3 million per zone or community. In addition, total qualified enterprise zone bond financing for each principal user of these bonds may not exceed $20 million for all zones and communities.

Description of Proposal

Two additional empowerment zones with same tax incentives as previously designated empowerment zones

The Secretary of HUD would be authorized to designate two additional empowerment zones located in urban areas (thereby increasing to eight the total number of empowerment zones located in urban areas) with respect to which would apply the same tax incentives (i.e., the wage credit, additional expensing, and special tax-exempt financing) as are available within the empowerment zones authorized by OBRA 1993. The two additional empowerment zones would be subject to the same eligibility criteria under present-law section 1392 that applied to the original six urban empowerment zones. In order to permit designation of these two additional empowerment zones, the proposal would increase the present-law 750,000 aggregate population cap applicable to empowerment zones located in urban areas to a cap of one million aggregate population for the eight urban empowerment zones. No additional Federal grants would be authorized.

The two empowerment zones would be required to be designated within 180 days after enactment, and the designations generally would remain in effect for 10 years.

Designation of additional empowerment zones and enterprise communities

In addition, the proposal would authorize the Secretaries of HUD and Agriculture to designate an additional 20 empowerment zones (no more than 15 in urban areas and no more than five in rural areas) and an additional 80 enterprise communities (no more than 50 in urban areas and no more than 30 in rural areas).[17] With respect to these additional empowerment zones and enterprise communities, the present-law eligibility criteria would be expanded slightly. First, the square mileage limitations of present law (i.e., 20 square miles for urban areas and 1,000 for rural areas) would be expanded to allow the empowerment zones to include an additional 2,000 acres and enterprise communities to include an additional 1,000 acres. This additional acreage, which could be developed for commercial or industrial purposes, would not be subject to the poverty rate criteria and could be divided among up to three

[16] For purposes of the tax-exempt financing rules, an "enterprise zone business" also includes a business located in a zone or community which would qualify as an enterprise zone business if it were separately incorporated.

[17] Under the proposal, the five rural empowerment zones and 30 rural enterprise communities could include areas located within an Indian reservation.

noncontiguous parcels. In addition, rather than applying the three-tiered poverty rate criteria applicable under present law to empowerment zones and enterprise communities, the additional 20 empowerment zones and 80 enterprise communities would be limited to census tracts with poverty rates of 25 percent or more.[18] For this purpose, census tracts with populations under 2,000 would be treated as satisfying the 25-percent poverty rate criteria if (1) at least 75 percent of the tract was zoned for commercial or industrial use and (2) the tract was contiguous to one or more other tracts that actually have a poverty rate of 25 percent or more.

Within the 20 additional empowerment zones, qualified "enterprise zone businesses" would be eligible to receive up to $20,000 of additional section 179 expensing[19] and to utilize special tax-exempt financing benefits. The Administration's proposed "brownfields" tax incentive (described elsewhere) also would be available within all designated empowerment zones. Businesses within the 20 additional empowerment zones would *not*, however, be eligible to receive the present-law wage credit available within the 11 other designated empowerment zones (i.e., the wage credit would be available only in the nine present-law zones and two urban zones designated under the first part of the proposal).

Within the 80 additional enterprise communities, qualified "enterprise zone businesses" would (as within the present-law enterprise communities) be eligible to utilize special tax-exempt financing benefits, as well as the "brownfields" tax incentives that applies to all designated zones and communities.

The 20 additional empowerment zones and 80 additional enterprise communities would be required to be designated before 1998, and the designations generally would remain in effect for 10 years.

Modification of definition of enterprise zone business

The proposal would modify the present-law requirement of section 1397B that an entity may qualify as an "enterprise zone business" only if (in addition to the other present-law criteria) at least 80 percent of the total gross income of such entity is derived from the active conduct of a qualified business within an empowerment zone or enterprise community. The proposal would liberalize this present-law requirement by reducing the percentage threshold so that an entity could qualify as an enterprise zone business if at least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business within an empowerment zone or enterprise community (assuming that the other criteria of section 1397B are satisfied).

In addition, the section 1397B would be modified so that rather than requiring that "substantially all" tangible and intangible property (and employee services) of an enterprise zone business be used (and performed) within a designated zone or community, a "substantial portion" of tangible and intangible property (and employee services) of an enterprise zone business would be required to be used (and performed)) within a designated zone or commu-

[18] In lieu of the poverty criteria, outmigration may be taken into account in designating a limited number of new rural enterprise communities.

[19] However, the additional section 179 expensing would *not* be available within the additional 2,000 acres allowed to be included under the proposal within an empowerment zone.

nity. Moreover, the proposal would further amend the section 1397B rule governing intangible assets so that a substantial portion of an entity's intangible property must be used in the active conduct of a qualified business within a zone or community, but there will be no need (as under present law) to determine whether the use of such assets is "exclusively related to" such business. However, the present-law rule of section 1397B(d)(4) would continue to apply, such that a "qualified business" would not include any trade or business consisting predominantly of the development or holding or intangibles for sale or license. The proposal also would clarify that an enterprise zone business that leases to others commercial property within a zone or community may rely on a lessee's certification that the lessee is an enterprise zone business. Finally, the proposal would provide that the rental to others of tangible personal property shall be treated as a qualified business if and only if at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of a zone or community (rather than the present-law requirement that "substantially all" tangible personal property rentals of an enterprise zone business satisfy this test).

This modified "enterprise zone business" definition would apply to all previously designated and newly designated empowerment zones and enterprise communities.

Tax-exempt financing rules

Exceptions to volume cap

The proposal would allow "new empowerment zone facility bonds" to be issued for qualified enterprise zone businesses in the 20 additional empowerment zones authorized to be designated under the proposal. These bonds would not be subject to the State private activity bond volume caps or the special limits on issue size applicable to qualified enterprise zone facility bonds under present law. The maximum amount of these bonds that could be issued would be limited to $30,000,000 per rural zone, $140,000,000 per urban zone with a population of less than 100,000, and $240,000,000 per urban zone with a population of 100,000 or more.

Changes to certain rules applicable to both empowerment zone facility bonds and qualified enterprise community facility bonds

Qualified enterprise zone businesses located in newly designated empowerment zones and enterprise communities, as well as those located in previously designated empowerment zones and enterprise communities, would be eligible for special tax-exempt bond financing under present-law rules, subject to the modifications described below (and the exception to the volume cap described above for newly designated empowerment zones).

The proposal would waive until the end of a "startup period" the requirement that 95 percent or more of the proceeds of bond issue be used by a qualified enterprise zone business. With respect to each property the startup period would end at the beginning of the first taxable year beginning more than two years after the later of (1) the date of the bond issue financing such property, or (2) the

date the property was placed in service (but in no event more than three years after the date of bond issuance). This waiver would only be available if at the beginning of the startup period there is a reasonable expectation that the use by a qualified enterprise zone business would be satisfied at the end of the startup period and the business makes bona fide efforts to satisfy the enterprise zone business definition.

The proposal also would waive the requirements of an enterprise zone business (other than the requirement that at least 35 percent of the business' employees be residents of the zone or community) for all years after a prescribed testing period equal to first three taxable years after the startup period.

Finally, the proposal would relax the rehabilitation requirement for financing existing property with qualified enterprise zone facility bonds. In the case of property which is substantially renovated by the taxpayer, the property would not need to be acquired by the taxpayer after zone or community designation or originally used by the taxpayer within the zone if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceeded 15 percent of the taxpayer's basis at the beginning of the period, or $5,000 (whichever is greater).

Effective Date

The proposed two additional urban empowerment zones (within which would be available the same tax incentives as are available in the empowerment zones designated pursuant to OBRA 1993) would be designated within 180 days after enactment. The proposed 20 additional empowerment zones (within which the wage credit would not be available) and the 80 additional enterprise communities would be designated after enactment but prior to January 1, 1998. For purposes of the additional section 179 expensing available within empowerment zones, the modifications to the definition of "enterprise zone business" would be effective for taxable years beginning on or after the date of enactment.

The proposed changes to the tax-exempt financing rules would be effective for qualified enterprise zone facility bonds and the new empowerment zone facility bonds issued after the date of enactment.

2. Expensing of environmental remediation costs ("Brownfields")

Present Law

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury Regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury Regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a

new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Treasury Regulations provide that capital expenditures include the costs of acquiring or substantially improving buildings, machinery, equipment, furniture, fixtures and similar property having a useful life substantially beyond the current year. In *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992), the Supreme Court required the capitalization of legal fees incurred by a taxpayer in connection with a friendly takeover by one of its customers on the grounds that the merger would produce significant economic benefits to the taxpayer extending beyond the current year; capitalization of the costs thus would match the expenditures with the income produced. Similarly, the amount paid for the construction of a filtration plant, with a life extending beyond the year of completion, and as a permanent addition to the taxpayer's mill property, was a capital expenditure rather than an ordinary and necessary current business expense. *Woolrich Woolen Mills v. United States*, 289 F.2d 444 (3d Cir. 1961) .

Although Treasury regulations provide that expenditures that materially increase the value of property must be capitalized, they do not set forth a method of determining how and when value has been increased. In *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), nonacq., 1964-2 C.B. 8, the U.S. Tax Court held that increased value was determined by comparing the value of an asset after the expenditure with its value before the condition necessitating the expenditure. The Tax Court stated that "an expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."

In several Technical Advice Memoranda (TAM), the Internal Revenue Service (IRS) declined to apply the *Plainfield Union* valuation analysis, indicating that the analysis represents just one of several alternative methods of determining increases in the value of an asset. In TAM 9240004 (June 29, 1992), the IRS required certain asbestos removal costs to be capitalized rather than expensed. In that instance, the taxpayer owned equipment that was manufactured with insulation containing asbestos; the taxpayer replaced the asbestos insulation with less thermally efficient, non-asbestos insulation. The IRS concluded that the expenditures resulted in a material increase in the value of the equipment because the asbestos removal eliminated human health risks, reduced the risk of liability to employees resulting from the contamination, and made the property more marketable. Similarly, in TAM 9411002 (November 19, 1993), the IRS required the capitalization of expenditures to remove and replace asbestos in connection with the conversion of a boiler room to garage and office space. However, the IRS permitted deduction of costs of encapsulating exposed asbestos in an adjacent warehouse.

In 1994, the IRS issued Rev. Rul. 94-38, 1994-1 C.B. 35, holding that soil remediation expenditures and ongoing water treatment expenditures incurred to clean up land and water that a taxpayer

contaminated with hazardous waste are deductible. In this ruling, the IRS explicitly accepted the *Plainfield Union* valuation analysis.[20] However, the IRS also held that costs allocable to constructing a groundwater treatment facility are capital expenditures.

More recently, the IRS issued TAM 9541005 (October 13, 1995) requiring a taxpayer to capitalize certain environmental study costs, as well as associated consulting and legal fees. The taxpayer acquired the land and conducted activities causing hazardous waste contamination. After the contamination, but before it was discovered, the company donated the land to the county to be developed into a recreational park. After the county discovered the contamination, it reconveyed the land to the company for $1. The company incurred the costs in developing a remediation strategy. The IRS held that the costs were not deductible under section 162 because the company acquired the land in a contaminated state when it purchased the land from the county. In a TAM issued on January 17, 1996, the IRS revoked and superseded TAM 9541005. Noting that the company's contamination of the land and liability for remediation were unchanged during the break in ownership by the county, the IRS concluded that the break in ownership should not, in and of itself, operate to disallow a deduction under section 162.

Description of Proposal

The proposal would provide that taxpayers could elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site would not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property which would otherwise be allocated to the site under the principles set forth in *Comm'r v. Idaho Power Co.*[21] and section 263A would be treated as qualified environmental remediation expenditures.

A "qualified contaminated site" generally would be any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas generally would include (1) empowerment zones and enterprise communities (as designated under current law and to be designated under the proposal); (2) sites announced before February 1, 1996, as being included in the brownfields pilot project of the Environmental Protection Agency

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[20] Rev. Rul. 94-38 generally rendered moot the holding in TAM 9315004 (December 17, 1992) requiring a taxpayer to capitalize certain costs associated with the remediation of soil contaminated with polychlorinated biphenyls (PCBs).

[21] *Comm'r v. Idaho Power Co.*, 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

(EPA); (3) any population census tract with a poverty rate of not less than 20 percent; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. Sites that are identified on the national priorities list under Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) could not be targeted areas. Appropriate State agencies would be designated by the EPA; if no State agency is designated, the EPA would be responsible for providing the certification. Hazardous substances generally would be defined as under sections 101(14) and 102 of CERCLA, but would not include substances with respect to which a removal or remedial action is not permitted under section 104(a)(3) of CERCLA.

The proposal further would provide that, in the case of property to which a qualified environmental remediation expenditure otherwise would have be capitalized, any deduction allowed under the proposal would be treated as a depreciation deduction and the property would be treated as subject to section 1245. Thus, deductions for qualified environmental remediation expenditures would be subject to recapture as ordinary income upon sale or other disposition of the property.

Effective Date

The proposal would apply to expenditures paid or incurred after the date of enactment, in taxable years ending after such date. Pursuant to the "tax cut sunset" provision of the proposal, this provision would sunset for taxable years beginning after December 31, 2000. Thus, expenditures paid or incurred in taxable years beginning after December 31, 2000, would not constitute "qualified environmental remediation expenditures." However, the President has proposed that the provision be reinstated if the fiscal dividend for the year 2000 is at least $20 billion.

V. CORPORATE REFORM AND OTHER TAX PROVISIONS

A. Expatriation Tax Provisions

Present Law

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

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

An individual who relinquishes U.S. citizenship with a principal purpose of avoiding U.S. taxes is subject to tax on his or her U.S. source income at the rates applicable to U.S. citizens, rather than the rates applicable to other nonresident aliens, for ten years after expatriation. Solely for this purpose, gains on the sale of property located in the United States and stocks and securities issued by U.S. persons are treated as U.S. source income. This alternative method of income taxation applies only if it results in a higher U.S. tax liability than the amount otherwise determined for nonresident aliens.

Rules applicable in the estate and gift tax contexts expand the categories of items that are subject to estate and gift taxes in the case of a U.S. citizen who relinquished citizenship with a principal purpose of avoiding U.S. taxes within the ten-year period ending on the date of transfer. Certain U.S. property controlled by such individuals and related persons is included in the individual's estate, and gifts of U.S.-situs tangible property by such individuals are subject to the gift tax.

Description of Proposal

In general

The proposal would replace the present-law expatriation income tax rules with rules that generally subject certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who relinquish their U.S. residency to tax on the net unrealized gain in their property as if such property were sold for fair market value on the expatriation date. The proposal also would impose information reporting obligations on U.S. citizens who relinquish their citizenship and long-term residents whose U.S. residency is terminated. In addition, the proposal would deny the section 102 exclusion in the case of gifts or inheritances received from an individual who was subject to the expatriation tax.

Individuals covered

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

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

Exceptions from the expatriation tax under the proposal would be provided for individuals in two situations. The first exception would apply to an individual who was born with citizenship both in the United States and in another country, provided that (1) as of the date of relinquishment of U.S. citizenship the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was a resident of the United States for no more than 8 out of the 15 taxable years ending with the year in which the relinquishment of U.S. citizenship occurred. The second exception would apply to a U.S. citizen who relinquishes citizenship before reaching age 18½, provided that the individual was a resident of the United States for no more than 5 taxable years before such relinquishment.

Deemed sale of property upon expatriation

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

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

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

Deferral of payment of tax

Under the proposal, an individual would be permitted to elect, on a property-by-property basis, to defer payment of the expatriation tax with respect to the deemed sale of any property. Under this election, the expatriation tax with respect to a particular property would be calculated based on the fair market value of the property on the date of expatriation, but the tax (plus interest thereon) would not be due until the property is subsequently disposed of. For this purpose, except as provided in regulations, the disposition of property in a nonrecognition transaction would constitute a disposition. In addition, if an individual holds property until his or her death, the individual would be treated as having disposed of the property immediately before death. In order to elect deferral of the expatriation tax, the individual would be required to provide adequate security to ensure that the deferred expatriation tax and interest ultimately will be paid. A bond in the amount of the deferred tax and interest would constitute adequate security. Other security mechanisms would also be permitted provided that the individual establishes to the satisfaction of the Secretary of the Treasury that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct such situation, the deferred expatriation tax and interest with respect to such property would become due. As a further condition to making this election, the individual would be required to consent to the waiver of any

treaty rights that would preclude the collection of the expatriation tax.

Interests in trusts

In general

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

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

Nonqualified trusts

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

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

Qualified trusts

If the individual has an interest in a qualified trust, a different set of rules would apply. Under these rules, the amount of unrealized gain allocable to the individual's trust interest would be calculated at the time of expatriation. In determining this amount, all contingencies and discretionary interests would be assumed to be resolved in the individual's favor (i.e., the individual is allocated the maximum amount that he or she potentially could receive

under the terms of the trust instrument). The expatriation tax imposed on such gains generally would be collected when the individual receives distributions from the trust, or, if earlier, upon the individual's death. Interest would be charged for the period between the date of expatriation and the date on which the tax is paid.

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

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

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

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

would be personally liable therefor, and any other beneficiary of the trust would have a right of contribution against such individual with respect to such tax.

Election to be treated as a U.S. citizen

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

Date of relinquishment of citizenship

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

Effect on present-law expatriation provisions

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

Treatment of gifts and inheritances from an expatriate

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

Required information reporting and sharing

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

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

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

Effective Date

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

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

The information reporting and sharing provisions would apply to all individuals whose date of relinquishment of U.S. citizenship or termination of U.S. residency occurs on or after February 6, 1995.

The tentative tax would not be required to be paid, and the reporting requirements would not be required to be met, until 90 days after the date of enactment.

B. Corporate Tax Reforms

1. Basis of substantially identical securities determined on an average basis

Present Law

A taxpayer generally recognizes gain or loss on the sale of property measured by the difference between the amount realized on the disposition and the taxpayer's adjusted basis in the property. The gain or loss may be treated as long-term capital gain or loss depending upon the character and holding period of the property. Under Treasury regulations, if a taxpayer sells a portion of his or her holdings in stocks or bonds, the taxpayer is allowed to identify the securities disposed of for purposes of determining gain or loss on the disposition. If the taxpayer does not make an adequate identification, he or she is deemed to have disposed of the securities first acquired. Mutual fund investors are allowed to determine the adjusted bases of their shares based on the average cost of all such shares.

Description of Proposal

In the case of substantially identical securities, the basis of the securities would be determined on an average basis. If a taxpayer disposes of less than all of such securities, the taxpayer would be treated as having disposed of the securities first acquired. The Secretary of the Treasury may provide, by regulation, that the average basis rule would not apply to certain securities even if such securities are substantially identical to other securities of the taxpayer. For this purpose, a "security" means any: (1) stock in a corporation; (2) a partnership or beneficial interest in widely held or publicly traded partnership or trust; (3) a note, bond, debenture, or other evidence of indebtedness; or (4) evidence in an interest in, or a derivative financial instrument in, any security described above, including any option, forward contract, short position, and any similar financial instrument in such a security or currency.

Effective Date

The proposal would be effective for determinations made 30 days after the date of enactment.

2. Require recognition of gain on certain appreciated positions in personal property

Present Law

In general, gain or loss is taken into account for tax purposes when realized. Gain or loss is usually realized with respect to a capital asset at the time the asset is sold, exchanged, or otherwise disposed of. Gain or loss is determined by comparing the amount realized with the adjusted basis of the particular property sold. In the case of corporate stock, the basis of shares purchased at different dates or different prices is generally determined by reference to the actual lot sold if it can be identified. Special rules under the Code can defer or accelerate recognition in certain situations.

The recognition of gain or loss is postponed for open transactions. For example, in the case of a "short sale" (i.e., when a taxpayer sells borrowed property such as stock and closes the sale by returning identical property to the lender) no gain or loss on the transaction is recognized until the closing of the borrowing.

Transactions designed to reduce or eliminate risk of loss on financial assets generally do not cause realization. For example, a taxpayer may lock in gain on securities by entering into a "short sale against the box" , i.e., when the taxpayer owns securities that are the same as, or substantially identical to, the securities borrowed and sold short. The form of the transaction is respected for income tax purposes and gain on the substantially identical property is not recognized at the time of the short sale. Pursuant to rules that allow specific identification of securities delivered on a sale, the taxpayer can obtain open transaction treatment by identifying the borrowed securities as the securities delivered. When it is time to close out the borrowing, the taxpayer can choose to deliver either the securities held or newly purchased securities. The Code provides rules only to prevent taxpayers from using short sales against the box to accelerate loss or to convert short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss.

Taxpayers can also lock in gain on certain property by entering into straddles without recognizing gain for tax purposes. A straddle consists of offsetting positions with respect to personal property. A taxpayer can take losses on positions in straddles into account only to the extent the losses exceed the unrecognized gain in the other positions in the straddle. In addition, rules similar to the short sale rules prevent taxpayers from changing the tax character of gains and losses recognized on straddles.

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

The Code accelerates the recognition of gains and losses in certain cases. For example, taxpayers are required each year to mark to market certain regulated futures contracts, foreign currency contracts, non-equity options, and dealer equity options, and to take any capital gain or loss thereon into account as 40 percent short-term and 60 percent long-term. Securities dealers are also required to mark their securities to market.

Description of Proposal

The proposal would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in either stock, a debt instrument, or a partnership interest. A taxpayer would be treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain limited circumstances, a person related to the taxpayer) substantially eliminates risk of loss and opportunity for gain by entering into one or more positions with respect to the same or substantially identical property. For example, a taxpayer that holds appreciated stock and enters into a short position with respect to that stock would recog-

nize any gain on the stock. An equity swap with regard to the stock that substantially eliminates risk of loss and opportunity for gain would also be subject to provision. Similarly, a taxpayer that holds appreciated stock and grants a call option or enters into a put option on the stock would generally recognize gain on the stock if there is a substantial certainty that the option will be exercised. In addition, a taxpayer would recognize gain on an appreciated position in stock, debt or partnership interests if the taxpayer enters into a transaction that is marketed or sold as substantially eliminating the risk of loss and opportunity for gain, regardless of whether the transaction involves the same or substantially identical property.

The taxpayer would recognize gain in a constructive sale as if the position were sold at its fair market value on the date of the sale and immediately repurchased. An appropriate adjustment (such as an increase in the basis of the position) would be made in the amount of any additional gain or loss subsequently realized with respect to the position; and a new holding period of such position would begin as if the taxpayer had acquired the position on the date of the constructive sale.

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

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

A constructive sale also would not include any contract for the sale of any stock, debt instrument, or partnership interest that is not a marketable security (as defined in the section 453(f)(2) rules that apply to installment sales) if the sale is reasonably expected to occur within one year after the date such contract is entered into.

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

If there is a constructive sale of less than all of the appreciated financial positions held by the taxpayer, the provision would apply to such positions in the order in which acquired or entered into. If the taxpayer actually disposed of a position previously constructively sold, the offsetting positions creating the constructive sale still held by the taxpayer would be treated as causing a new constructive sale of appreciated positions in substantially identical property, if any, the taxpayer holds at that time.

The application of the proposal would be affected by the separate proposal to require average cost basis for securities. For example, that proposal would affect the computation of the amount of gain with respect to any constructive sale to which it applies.

Effective Date

The proposal would be effective for constructive sales entered into after the date of enactment. It also would apply to constructive sales entered into after January 12, 1996 and before the date of enactment that remain open 30 days after the date of enactment. The proposal would apply to these pre-enactment transactions as if the constructive sale occurred on the date which is 30 days after the date of enactment.

In the case of a decedent dying after the date of enactment, if a constructive sale of an appreciated financial position (as defined in the proposal) had occurred before the date of enactment and remains open on the day before the decedent's death, and no gain had been recognized under the constructive sale rules on the position, such position (and any property related to it, under principles of the provision) would be treated as property constituting rights to receive income in respect of a decedent under section 691.

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

Present Law

In general

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is not subject to tax (tax-exempt obligations) (sec. 265). This rule applies to tax-exempt obligations held by individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues indebtedness and a related person acquires or holds tax-exempt obligations.[22]

Application to non-financial corporations

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

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

Two-percent de minimis exception.—In the case of an individual, interest on indebtedness generally is not disallowed if during the

[22] Section 7701(f) (as enacted in the Deficit Reduction Act of 1984 (sec. 53(c) of Pub. L. No. 98-369)) provides that the Treasury Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of any income tax rules which deal with linking of borrowing to investment or diminish risk through the use of related persons, pass-through entities, or other intermediaries.

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

Interest on installment sales to State and local governments.—If a taxpayer sells property to a State or local government in exchange for an installment obligation, interest on the obligation may be exempt from tax. Present law has been interpreted to not disallow interest on a taxpayer's indebtedness if the taxpayer acquires nonsalable tax-exempt obligations in the ordinary course of business in payment for services performed for, or goods supplied to, State or local governments.[23]

Application to financial corporations

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

Description of Proposal

The proposal would extend to all corporations the rule that applies to financial institutions that disallows interest deductions of a taxpayer (that are not otherwise disallowed as allocable under present law to tax-exempt obligations) in the same proportion as the average basis of its tax-exempt obligations bears to the average basis of all of the taxpayer's assets. The proposal would not extend the small-issuer exception to taxpayers which are not financial institutions. Nonetheless, the proposal would not apply to nonsalable tax-exempt debt acquired by a corporation in the ordinary course of business in payment for goods or services sold to a State or local government. Under the proposal, insurance companies would not be subject to the pro rata rule. Finally, the proposal would apply the interest disallowance provision to all related persons (within the meaning of section 267(f)). Accordingly, in the case of related parties that are members of the same consolidated group, the pro rata disallowance rule would apply as if all the members of the group were a single taxpayer. The consolidated group rule would be applied without regard to any member that is an insurance com-

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

pany. In the case of related persons that are not members of the same consolidated group, the tracing rules would be applied by treating all of the related persons as a single entity. The proposal is not intended to affect the application of section 265 to related parties under current law.

Effective Date

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

4. Deny interest deduction on certain debt instruments

Present Law

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

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

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

Description of Proposal

Under the proposal, no deduction would be allowed for interest or OID on an instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that (1) has a maximum weighted average maturity of more than 40 years, or (2) is payable in stock of the issuer or a related party (within the meaning of sections 267(b) and 707(b)), including an instrument a substantial portion of which is mandatorily convertible or convertible at the issuer's option into stock of the issuer or a related party. In addition, an instrument would be treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the issuer or related party. An instrument would also be treated as payable in stock if it is part of an arrangement designed to result in the payment of the instrument with such stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised.

The proposal would also clarify that for purposes of section 385(c), an issuer will be treated as having characterized an instrument as equity if the instrument (1) has a maximum term of more than 20 years, and (2) is not shown as indebtedness on the separate balance sheet of the issuer. For this purpose, in the case of an instrument with a maximum term of more than 20 years issued to a related party (other than a corporation) that is eliminated in the consolidated balance sheet that includes the issuer and the holder, the issuer will be treated as having characterized the instrument as equity if the holder or some other related party issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not be treated as shown as indebtedness on a balance sheet because it is described as such in footnotes or other narrative disclosures. The proposal would apply only to corporations that file annual financial statements (or are included in financial statements filed) with the Securities and Exchange Commission (SEC), and the relevant balance sheet is the balance sheet filed with the SEC. In addition, this proposal would not apply to leveraged leases.

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

The proposal generally would not apply to demand loans, redeemable ground rents or any other indebtedness specified by regulation.

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

Effective Date

The proposal would be effective for instruments issued on or after December 7, 1995. The proposal would not apply, however, to instruments: (1) issued pursuant to a commitment that was binding on December 6, 1995 and at all times thereafter until the instrument is issued; (2) issued pursuant to an exchange offer which was outstanding on December 6, 1995; (3) priced for purposes of issuance on or before such date; (4) issued pursuant to a registration statement filed with the Securities and Exchange Commission ("SEC") on or before December 7, 1995 (other than a statement that contemplates a delayed or continuous offering of instruments), to the extent the instruments are described in, and the aggregate amount of the instruments does not exceed the aggregate the amount stated in, the registration statement; (5) issued pursuant to a registration statement that contemplates delayed or continuous offering filed with the SEC on or before December 7, 1995 to the extent the instruments are described in, and the aggregate amount of the instruments does not exceed the amount stated in, a prospectus supplement (including a preliminary prospectus supplement) filed on or before December 7, 1995, or, if the preliminary prospectus does not state a maximum amount to be issued, the aggregate amount expected to be offered as established by contemporaneous, written evidence; or (6) issued pursuant to a private placement under SEC rule 144A if, on or before December 7, 1995, the issuer had made a public announcement of its intention to issue the instruments and an offering circular or memorandum (in-

cluding a preliminary offering circular or memorandum) with respect to the debt had been distributed to prospective investors, but only to the extent the instruments were described in, and the amount of the instruments does not exceed the amount stated in, the offering circular or memorandum; and (7) any instruments issued before the 30th day after the enactment of this proposal as part of an issue that is substantially identical (other than yield) to an issue which was publicly announced as having been sold on December 7, 1995, but which was terminated on or after such date.

5. Defer interest deduction on certain convertible debt

Present Law

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

Other convertible instruments may be issued with coupon interest, rather than OID, and may provide that if the debt is converted into stock, the holder does not receive any interest that accrued but was unpaid between the latest coupon date and the conversion date. Under present law, the issuer of such instrument generally cannot deduct such accrued but unpaid interest.[24]

Description of Proposal

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

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

debt would continue to include the interest on such instruments in gross income as under present law.

Effective Date

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

6. Gains and losses from certain terminations with respect to property

Present Law

Extinguishment treated as sale or exchange.—The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or

abandonment, the disposition produces ordinary income or loss.[25] Under a special provision, gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to certain personal property are treated as gains or losses from the sale of a capital asset (sec. 1234A). The personal property subject to this rule is (1) personal property (other than stock that is not part of straddle or of a corporation that is not formed or availed of to take positions which offset positions in personal property of its shareholders) of a type which is actively traded and which is, or would be on acquisition, a capital asset in the hands of the taxpayer and (2) a "section 1256 contract"[26] which is capital asset in the hands of the taxpayer. Section 1234A does not apply to the retirement of a debt instrument.

Character of gain on retirement of debt obligations.—Amounts received on the retirement of any debt instrument are treated as amounts received in exchange therefor (sec. 1271(a)(1)). In addition, gain on the sale or exchange of a debt instrument with OID[27] generally is treated as ordinary income to the extent of its OID if there was an intention at the time of its issuance to call the debt instrument before maturity (sec. 1271(a)(2)). These rules do not apply to (1) debt issued by a natural person or (2) debt issued before July 2, 1982, by a noncorporate or nongovernment issuer.

Description of Proposal

Extension of relinquishment rule to all types of property.—The proposal would extend the rule which treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation which is (or on acquisition would be) a capital asset in the hands of the taxpayer to all types of property.

Character of gain on retirement of debt obligations issued by natural persons.—The proposal would repeal the provision that exempts debt obligations issued by natural persons from the rule which treats gain realized on retirement of the debt as exchanges. Thus, under the proposal, gain or loss on the retirement of such debt will be capital gain or loss. The proposal would retain the present-law exceptions for debt issued before July 2, 1982, by noncorporations or nongovernments.

Effective Date

Extension of relinquishment rule to all types of property.—The extension of the extinguishment rule would apply to positions established after the 30th day after the date of enactment.

Character of gain on retirement of debt obligations issued by natural persons.—The repeal of the exception to the character of gain

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[25] See *Fairbanks v. U.S.*, 306 U.S. 436 (1039); *Comm'r v. Pittston Co.*, 252 F. 2d 344 (2nd Cir.), cert. denied, 357 U.S. 919 (1958).

[26] A "section 1256 contract" means (1) any regulated futures contract, (2) foreign currency contract, (3) nonequity option, or (4) dealer equity option.

[27] The issuer of a debt instrument with OID generally accrues and deducts the discount, as interest, over the life of the obligation even though the amount of such interest is not paid until the debt matures. The holder of such a debt instrument also generally includes the OID in income as it accrues as interest on an accrual bases. The mandatory inclusion of OID in income does not apply, among other exceptions, to debt obligations issued by natural persons before March 2, 1984, and loans of less than $10,000 between natural persons if such loan is not made in the ordinary course of business of the lender (secs. 1272(a)(2)(D) and (E)).

on retirement of debt instruments issued by natural persons or obligations issued before July 2, 1982, would apply to sales or exchanges and terminations after the 30th day after the date of enactment.

7. Determination of original issue discount where pooled debt obligations subject to acceleration

Present Law

A taxpayer generally may deduct the amount of interest paid or accrued within the taxable year on indebtedness issued by the taxpayer. The issuer of a debt instrument with original issue discount ("OID") generally accrues and deducts, as interest, the OID over the life of the obligation, even though the amount of the interest may not be paid until the maturity of the instrument.

The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity includes all amounts payable at maturity. The amount of OID in a debt instrument is allocated over the life of the instrument through a series of adjustments to the issue price for each accrual period. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. Thus, in order to compute the amount of OID and the portion of OID allocable to a period, the stated redemption price at maturity and the time of maturity must be known.

Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. Specifically, in the case of (1) any regular interest in a REMIC, (2) qualified mortgages held by a REMIC, or (3) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, the daily portions of the OID on such debt instruments are determined by taking into account an assumption regarding the prepayment of principal for such instruments.

Description of Proposal

The proposal would apply the special OID rule applicable to any regular interest in a REMIC, qualified mortgages held by a REMIC, or certain other debt instruments to any pool of debt instruments the payments on which may be accelerated by reason of prepayments.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment. If a taxpayer is required to change its method of accounting under the proposal, such change would be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury and any section 481 adjustment would be included in income ratably over a four-year period beginning with the first taxable year beginning after the date of enactment.

8. Require gain recognition for certain extraordinary dividends

Present Law

A corporate shareholder generally can deduct at least 70 percent of a dividend received from another corporation. This dividends received deduction is 80 percent if the corporate shareholder owns at least 20 percent of the distributing corporation and generally 100 percent if the shareholder owns at least 80 percent of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was received by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non pro rata redemption or a partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain on the sale or disposition of such stock, but not until that time (sec. 1059(a)(2)). The reduction in basis for this purpose occurs immediately before any sale or disposition of the stock (sec. 1059(d)(1)(A)). The Treasury Department has general regulatory authority to carry out the purposes of the section.

Except as provided in regulations, the extraordinary dividend provisions do not apply to result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns, where the dividend is eliminated or excluded under the consolidated return regulations. Double inclusion of earnings and profits (i.e., from both the dividend and from gain on the disposition of stock with a reduced basis) also should generally be prevented.[28] Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.[29]

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend (sec. 302). A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. Section 302(b) also contains several specific tests (e.g., a substantial reduction computation and a termination test) to identify redemptions that are not essentially equivalent to dividends. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of cash or other property received in a reorganization contain a similar reference (sec. 356(a)(2)).

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[28] See H.R. Rep. 99-841, II-166, 99th Cong. 2d Sess. (Sept. 18, 1986).

[29] See Treas. Reg. sec. 1.701-2(f), Example (2).

Description of Proposal

Under the proposal, except as provided in regulations, a corporate shareholder would recognize gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership.[30]

In addition, the proposal would require immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. The reduction in basis of stock would be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.

Reorganizations or other exchanges involving amounts that are treated as dividends under section 356(a)(2) of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e). For example, if a recapitalization or other transaction that involves a dividend under section 356 has the effect of a non pro rata redemption or is treated as a dividend due to options being counted as stock, the rules of section 1059 apply. Redemptions of shares, or other extraordinary dividends on shares, held by a partnership will be subject to section 1059 to the extent there are corporate partners (e.g., appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest will be required).

Under continuing section 1059(g) of present law, the Treasury Department would be authorized to issue regulations where necessary to carry out the purposes and prevent the avoidance of the bill.

Effective Date

The proposal would generally be effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on that date, or a tender offer outstanding on that date.[31] However, in applying the new gain recognition rules to any distribution that is not a partial liquidation, a non pro rata redemption, or a redemption that is treated as a dividend by reason of options, September 13, 1995 is substituted for May 3, 1995 in applying the transition rules.

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

In addition, no inference is intended regarding the rules under present law (or in any case where the treatment is not specified in the provision) for determining the shares of stock with respect to which a dividend is received or that experience a basis reduction.

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[30] Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient earnings and profits, the rule applies to the portion treated as a dividend.

[31] Thus, for example, in the case of a distribution prior to the effective date, the provisions of present law would continue to apply, including the provisions of present law sections 1059(a) and 1059(d)(1), requiring reduction in basis immediately before any sale or disposition of the stock, and requiring recognition of gain at the time of such sale or disposition.

9. Require gain recognition on certain distributions of controlled corporation stock

Present Law

A corporation is generally required to recognize gain on the distribution of property (including stock of a subsidiary) as if such property had been sold for its fair market value. The shareholders generally treat the receipt of property as a taxable event as well. Section 355 of the Internal Revenue Code provides an exception to this rule for certain distributions of stock in a controlled corporation, provided that various requirements are met, including certain restrictions relating to acquisitions and dispositions of stock of the distributing corporation ("distributing") or the controlled corporation ("controlled") prior and subsequent to a distribution.

Description of Proposal

The proposal would adopt additional restrictions under section 355 on acquisitions and dispositions of the stock of distributing and controlled. Under the proposal, the distributing corporation (but not the shareholders) would be required to recognize gain on the distribution of the stock of controlled unless the direct and indirect shareholders of distributing, as a group, control both distributing and controlled at all times during the four year period commencing two years prior to the distribution. Control for this purpose means ownership of stock possessing at least 50 percent of the total combined voting power and at least 50 percent of the total value of all classes of stock.

In determining whether shareholders retain control in both corporations throughout the four-year time period, any acquisitions or dispositions of stock that are unrelated to the distribution will be disregarded. A transaction is unrelated to the distribution if it is not pursuant to a common plan or arrangement that includes the distribution. For example, public trading of the stock of either distributing or controlled is disregarded, even if that trading occurs in contemplation of the distribution. Similarly, an acquisition of distributing or controlled in a merger or otherwise that is not pursuant to a common plan or arrangement existing at the time of the distribution is not related to the distribution. For example, a hostile acquisition of distributing or controlled commencing after the distribution will be disregarded. On the other hand, a friendly acquisition will generally be considered related to the distribution if it is pursuant to an arrangement negotiated (in whole or in part) prior to the distribution, even if at the time of distribution it is subject to various conditions, such as the approval of shareholders or a regulatory body.

Effective Date

The proposal would be effective for distributions after March 19, 1996 (the date of announcement) unless the distribution is: (1) made pursuant to a written agreement which was (subject to customary conditions) binding on or before such date and at all times thereafter; (2) described in a ruling request submitted to the IRS

on or before such date; or (3) described in a public announcement or SEC filing on or before such date.

10. Reform tax treatment of certain corporate stock transfers

Present Law

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. In determining whether a transaction so recharacterized is treated as a sale or a dividend, reference is made to the changes in the selling corporation's ownership of stock in the issuing corporation (applying the constructive ownership rules of section 318(a) with modifications under section 304(c)). Sales proceeds received by a corporate transferor that are characterized as a dividend may qualify for the dividends received deduction under section 243, and such dividend may bring with it foreign tax credits under section 902. Section 304 does not apply to transfers of stock between members of a consolidated group.

Section 1059 applies to "extraordinary dividends," including certain redemption transactions treated as dividends qualifying for the dividends received deduction. If a redemption results in an extraordinary dividend, section 1059 generally requires the shareholder to reduce its basis in the stock of the redeeming corporation by the nontaxed portion of such dividend.

Description of Proposal

Under the proposal, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation would be treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. Thus, the acquiring corporation would be treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. In addition, the proposal would amend section 1059 so that, if the section 304 transaction is treated as a dividend to which the dividends received deduction applies, the dividend would be treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account under section 1059.

Under the proposal, a special rule would apply to section 304 transactions involving acquisitions by foreign corporations. The proposal would limit the earnings and profits of the acquiring foreign corporation that would be taken into account in applying section 304. The earnings and profits of the acquiring foreign corporation to be taken into account would not exceed the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of section 951(b)) of such corporation, and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a con-

trolled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section 1248(d) (relating to certain exclusions from earnings and profits) would apply. The Secretary of the Treasury would prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

No inference is intended as to the treatment of any transaction under present law.

Effective Date

The proposal generally would apply to distributions and acquisitions after March 19, 1996. However, the proposal would not apply to any distribution or acquisition after such date that is (1) made pursuant to a written agreement that was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

11. Conversion of large corporations into S corporations treated as complete liquidation

Present Law

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

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

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

Certain rules attempt to limit the potential for C corporations to avoid corporate-level tax by shifting appreciated assets to S corporation status prior to the recognition of such gains. Specifically, an S corporation is subject to a tax computed by applying the highest marginal corporate tax rate to the lesser of (1) the S corporation's recognized built-in gains or (2) the amount that would be taxable income if such corporation was not an S corporation (sec. 1374). For this purpose, a recognized built-in gain generally is any gain the S corporation recognizes from the disposition of any asset

within a 10-year recognition period after the conversion from C corporation status or any income that is properly taken into account during the recognition period that is attributable to prior periods. However, a gain is not a recognized built-in gain if the taxpayer can establish that the asset was not held by the corporation on the date of conversion or to the extent the gain exceeds the amount of gain that would have been recognized on such date. In addition, the cumulative amount of recognized built-in gains that an S corporation must take into account may not exceed the amount by which the fair market value of the corporation's assets exceeds the aggregated adjusted basis of such assets on the date of conversion from C corporation status. Finally, net operating loss or tax credit carryovers from years in which the corporation was a C corporation may reduce or eliminate the tax on recognized built-in gains.

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

Description of Proposal

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

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

Effective Date

The proposal generally would be effective for subchapter S elections that become effective for taxable years beginning after January 1, 1997. The proposal would apply to acquisitions (e.g., the merger of a C corporation into an existing S corporation) after December 31, 1996.

12. Limit dividends received deduction

a. Reduce dividends received deduction to 50 percent

Present Law

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

tion is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

Description of Proposal

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

Effective Date

The proposal would be effective for dividends received or accrued after the 30th day after the date of enactment of the provision.

b. Modify holding period for dividends received deduction

Present Law

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

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46- or 91-day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest. The holding period must be satisfied only once, rather than with respect to each dividend received.

Description of Proposal

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

Effective Date

The proposal would be effective for dividends received or accrued after the 30th day after the date of the enactment of the provision.

13. Treat certain preferred stock as "boot"

Present law

In reorganization transactions within the meaning of section 368, no gain or loss is recognized except to the extent "other property" (often called "boot") is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock can be received tax-free in a reorganization, notwithstanding that many preferred stocks are functionally equivalent to debt securities. Upon the receipt of "other property", gain but not loss can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are

surrendered in the exchange. Other than this debt-for-debt rule, similar rules generally apply to transactions described in section 351.

Description of Proposal

The proposal would amend the relevant provisions (sections 351, 354, 355, 356 and 1036) to treat certain preferred stock as "other property" (i.e., "boot") subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351 or section 368, gain but not loss would be recognized.

The proposal would apply to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate, including through a conversion privilege, in corporate growth to any significant extent), where (1) the holder has the right to require the issuer or a related person (within the meaning of sections 267(b) and 707(b)) to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, the rules of (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. In addition, a right or obligation would be disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder or, in the case of stock transferred in connection with the performance of services, upon the holder's retirement.

The following exchanges would be excluded from this gain recognition: (1) certain exchanges of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) certain exchanges of debt securities for preferred stock of the same or lesser value; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation would be defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family would be defined by reference to the definition in section 447(e). Thus, a family would include children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member would be treated as not held by a family member to the extent a non-family

member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences still apply.

An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment under section 354, but not section 351. In cases in which both sections 354 and 351 may apply to a transaction, section 354 generally will apply for purposes of this proposal. Thus, in that situation, the exchange would be tax free.

The Treasury Secretary would have regulatory authority to (1) apply installment-sale type rules to preferred stock that is subject to this proposal in appropriate cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., sections 304, 306, 318, and 368(c)).

Effective Date

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

14. Registration of confidential corporate tax shelters

Present Law

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

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

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

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

Description of Proposal

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

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

A transaction is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter includes specified related parties.

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

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

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

The penalty for failing to timely register a corporate tax shelter is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments with respect to offerings after late registration). A similar penalty is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50-percent penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50-percent penalty to 75 percent of the applicable fees.

Effective Date

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

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

Present Law

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[32] Further, an exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured (sec. 101(a)). The policyholder may borrow with respect to the life insurance contract without affecting these exclusions, subject to certain limitations.

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

Further, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or

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

all of the increases in the cash value of the contract.[33] An exception to the latter rule is provided, permitting deductibility of interest on bona fide debt that is part of such a plan, if no part of 4 of the annual premiums due during the first 7 years is paid by means of debt (the "4-out-of-7 rule") (sec. 264(c)(1)). Provided the transaction gives rise to debt for Federal income tax purposes and provided the 4-out-of-7 rule is met,[34] a company may under present law borrow up to $50,000 per employee, officer, or financially interested person to purchase or carry a life insurance contract covering such a person, and is not precluded under section 264 from deducting the interest on the debt, even though the earnings inside the life insurance contract (inside buildup) are tax-free, and in fact the taxpayer has full use of the borrowed funds.

Description of Proposal

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

Effective Date

The proposal generally would be effective with respect to interest paid or accrued after December 31, 1995 (subject to a phase-in rule). The phase-in of the proposal would permit a deduction for 50 percent of certain otherwise deductible interest paid or accrued in 1996. Interest paid or accrued in 1997 and thereafter would not deductible.

The interest deduction allowed under the phase-in would be for 50 percent of the interest on debt incurred before September 18, 1995, with respect to a life insurance policy that was in effect on that date and that covers only the individual who was insured under that policy on that date, to the extent the rate of interest under the debt does not exceed the lesser of (1) the borrowing rate specified in the contract as of September 18, 1995, or (2) Moody's Corporate Bond Yield Average—Monthly Average Corporates for the month the interest is paid or accrued. Only interest that would have been allowed as a deduction but for the amendment made by the proposal would be allowed under the phase-in. Interest that is deductible under the phase-in rule would not include interest on borrowings by the taxpayer with respect to contracts on the lives of more than 20,000 insured individuals, effective for interest paid

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

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

or accrued after December 31, 1995. For this purpose, all persons treated as a single employer would be treated as one taxpayer.

Any amount included in income during 1996 or 1997, that is received under a contract described in the proposal on the complete surrender, redemption or maturity of the contract or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract, would be includable ratably over the first four taxable years beginning with the taxable year the amount would otherwise have been includable. Utilization of this 4-year income-spreading rule would not cause interest paid or accrued prior to January 1, 1998, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1) (i.e., a contract in which substantially all of the premiums are paid within 4 years after the date of purchase). In addition, the lapse of a contract after September 18, 1995, due to nonpayment of premiums, would not cause interest paid or accrued prior to January 1, 1998, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1).

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

16. Modifications of Puerto Rico and possessions tax credit

Present Law

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

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

A domestic corporation that has elected the section 936 credit and that satisfies these two conditions for a taxable year generally is entitled to a credit based on the U.S. tax attributable to the sum of the taxpayer's possession business income and its QPSII. However, the amount of the credit attributable to possession business income is subject to the limitations enacted by the Omnibus Budget Reconciliation Act of 1993. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes). In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage is phased down, beginning at 60 percent for 1994 and reaching 40 percent for 1998 and thereafter. The amount of the section 936 credit attributable to QPSII is not subject to these limitations.

Description of Proposal

The proposal would phase out the section 936 credit determined under the applicable percentage limit ratably over five years beginning in 1997. Under the proposal, taxpayers using the applicable percentage limit would continue to be subject to present law for taxable years beginning in 1996; accordingly, the section 936 credit attributable to possession business income for taxable years beginning in 1996 would be subject to the present-law applicable percentage limit of 50 percent of the amount otherwise allowed. For taxable years beginning in 1997, the section 936 credit attributable to possession business income would be reduced to 80 percent of the present-law applicable 45-percent limit; accordingly, the section 936 credit attributable to possession business income for taxable years beginning in 1997 would be limited to 36 percent of the amount otherwise allowed. For taxable years beginning in 1998, the section 936 credit attributable to possession business income would be reduced to 60 percent of the present-law applicable 40-percent limit; accordingly, the section 936 credit attributable to possession business income for taxable years beginning in 1998 would be limited to 24 percent of the amount otherwise allowed. For taxable years beginning in 1999, the section 936 credit attributable to possession business income would be reduced to 40 percent of the present-law applicable 40-percent limit; accordingly, the section 936 credit attributable to possession business income for taxable years beginning in 1999 would be limited to 16 percent of the amount otherwise allowed. For taxable years beginning in 2000, the section 936 credit attributable to possession business income would be reduced to 20 percent of the present-law applicable 40-percent limit; accordingly, the section 936 credit attributable to possession business income for taxable years beginning in 2000 would be limited to 8 percent of the amount otherwise allowed. For taxable years beginning in 2001 and thereafter, the section 936 credit determined under the applicable percentage limit would no longer be available.

In addition, the proposal would permit a taxpayer whose economic activity limit exceeds the credit for its possession business

income for a taxable year to carry forward such excess limit for up to five taxable years. The economic activity limit would be treated as used on a first-in, first-out basis.

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

Effective Date

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

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

Present Law

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in trade or business or for investment (sec. 1031). In general, any kind of real estate is treated as of a like-kind with other real property as long as the properties are both located either within or outside the United States. In addition, certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

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

Description of Proposal

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

Effective Date

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

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

Present Law

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

Description of Proposal

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

Effective Date

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

19. Repeal percentage depletion for nonfuel minerals mined on certain Federal lands

Present Law

Taxpayers are allowed to deduct a reasonable allowance for depletion relating to the acquisition and certain related costs of mines or other hard mineral deposits. The depletion deduction for any taxable year is calculated under either the cost depletion method or the percentage depletion method, whichever results in the greater allowance for depletion for the year.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of the units sold from that property during the taxable year, to the estimated total units remaining at the beginning of that year.

Under the percentage depletion method, a deduction is allowed in each taxable year for a statutory percentage of the taxpayer's gross income from the property. The statutory percentage for gold, silver, copper, and iron ore is 15 percent; the statutory percentage for uranium, lead, tin, nickel, tungsten, zinc, and most other hard rock minerals is 22 percent. The percentage depletion deduction for these minerals may not exceed 50 percent of the net income from the property for the taxable year (computed without allowance for depletion). Percentage depletion is not limited to the taxpayer's basis in the property; thus, the aggregate amount of percentage depletion deductions claimed may exceed the amount expended by the taxpayer to acquire and develop the property.

The Mining Law of 1872 permits U.S. citizens and businesses to freely prospect for hard rock minerals on Federal lands, and allows them to mine the land if an economically recoverable deposit is found. No Federal rents or royalties are imposed upon the sale of

the extracted minerals. A prospecting entity may establish a claim to an area that it believes may contain a mineral deposit of value and preserve its right to that claim by paying an annual holding fee of $100 per claim. Once a claimed mineral deposit is determined to be economically recoverable, and at least $500 of development work has been performed, the claim holder may apply for a "patent" to obtain title to the surface and mineral rights. If approved, the claimant can obtain full title to the land for $2.50 or $5.00 per acre.

Description of Proposal

The proposal would repeal the present-law percentage depletion provisions for nonfuel minerals extracted from any land where title to the land or the right to extract minerals from such land was originally obtained pursuant to the provisions of the Mining Law of 1872.

Effective Date

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

C. Foreign Tax Provisions

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

Present Law

Income taxation of trusts and their beneficiaries

Taxation of trusts

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

Taxation of distributions to beneficiaries

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

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

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

Grantor trust rules

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

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

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

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

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

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

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

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

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

Under the grantor trust rules, a grantor generally is treated as the owner of the trust's assets without regard to whether the grantor is a domestic or foreign person. Under these rules, U.S. trust beneficiaries can avoid U.S. tax on distributions from a trust where a foreign grantor is treated as owner of the trust, even though no tax may be imposed on the trust income by any jurisdiction.[35]

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

Foreign trusts that are not grantor trusts

In cases where the grantor trust rules do not apply to a foreign trust, its U.S. beneficiaries generally are taxable on their respective shares of the income of the trust that is required to be distributed, as well as any other income of the trust that is paid, credited, or distributed to them (secs. 652, 662). Distributions from a trust in excess of the trust's DNI[36] for the taxable year generally are treated as accumulation distributions (sec. 665(b)), subject to the throwback rules. Under these rules, a distribution by a foreign trust of previously accumulated income generally is taxed at the beneficiary's average marginal rate for the prior 5 years, plus interest (secs. 666, 667). Interest is computed at a fixed annual rate of 6 percent, with no compounding (sec. 668).

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

Residence of estates and trusts

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

The Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien indi-

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

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

vidual. Internal Revenue Service ("IRS") rulings and court cases, however, indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor, and the nationality of the beneficiaries.[37] If an examination of these factors indicates that a trust has sufficient foreign contacts, it is deemed comparable to a nonresident alien individual and, thus, is a foreign trust.

Section 1491 generally imposes a 35-percent excise tax on a U.S. person that transfers appreciated property to certain foreign entities, including a foreign trust.[38] In the case of a domestic trust that changes its situs and becomes a foreign trust, it is unclear whether property has been transferred from a U.S. person to a foreign entity, and, thus, whether the transfer is subject to section 1491.

Information reporting requirements and associated penalties

Any U.S. person who creates a foreign trust or transfers money or property to a foreign trust is required to report that event to the Treasury Department (sec. 6048(a)). Current regulations require reporting of, inter alia, the name, address and identification number (if any) of the transferor, the trust, the fiduciary and trust beneficiaries; the interest of each beneficiary; the location of the trust records; and the value of each item transferred (Treas. Reg. sec. 16.3-1(c)). Similarly, any U.S. person who transfers property to a foreign trust that has one or more U.S. beneficiaries is required to report annually to the Treasury Department (sec. 6048(c)). In addition, if the transfer of any appreciated property by a U.S. person is subject to section 1491, the transferor is required to report the transfer to the Treasury Department (Treas. Reg. sec. 1.1494-1(a)).

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

Description of Proposal

Overview

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

a. The grantor trust rules generally would apply only to the extent that they result, directly or indirectly, in amounts being cur-

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

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

rently taken into account in computing the income of a U.S. person. Certain exceptions would apply.

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

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

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

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

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

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

The proposed changes are described in more detail below.

a. Inbound foreign grantor trust rules

Foreign grantors not treated as owners

Under the proposal, the grantor trust rules generally would apply only to the extent that they result, directly or indirectly, in amounts being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. Thus, the grantor trust rules generally would not apply to any portion of

a trust where their effect would be to treat a foreign person as owner of that portion. The proposal would provide certain exceptions to this general rule. The proposal generally would not apply in the case of revocable trusts and trusts where the only amounts distributable during the lifetime of the grantor are to the grantor or the grantor's spouse. These exceptions would not apply to the extent of gifts made by a U.S. beneficiary of the trust to the foreign grantor. The proposal also would not apply to trusts established to pay compensation, and certain trusts in existence as of September 19, 1995.[39] In addition, the proposal generally would not apply where the grantor is a controlled foreign corporation, foreign personal holding company or passive foreign investment company.

In a case where the foreign grantor, who would be treated as the owner of the trust but for the above rule, actually pays tax on the income of the trust to a foreign country, it is anticipated that Treasury regulations would provide that U.S. beneficiaries who are subject to U.S. income tax on that income would be treated for foreign tax credit purposes as having paid the foreign taxes that were paid by the foreign grantor. Any resulting foreign tax credits would be subject to applicable foreign tax credit limitations.

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

Distributions by foreign trusts through nominees

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

Effective date

The proposal would be effective on the date of enactment.

b. Foreign trusts that are not grantor trusts

Interest charge on accumulation distributions

The proposal would change the interest rate applicable to accumulation distributions from foreign trusts from simple interest at a fixed rate of 6 percent to compound interest determined in the manner of the interest imposed on underpayments of tax under section 6621(a)(2). Simple interest would continue to accrue at the

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

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

The proposal would include an anti-abuse rule which authorizes the Secretary of the Treasury to issue regulations, on or after the date of enactment, that may be necessary or appropriate to carry out the purposes of the rules applicable to accumulation distributions, including regulations to prevent the avoidance of those purposes.

Loans to grantors or beneficiaries and use of trust property

In the case of a loan of cash or marketable securities by the foreign trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such grantor or beneficiary[40]), the proposal would treat the full amount of the loan as distributed to the grantor or beneficiary, even if the loan bears interest at an adequate rate and is subsequently repaid. In addition, any subsequent transaction between the trust and the original borrower regarding the principal of the loan (e.g., repayment) would be disregarded for all purposes of the Code.

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

Effective date

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

c. Outbound foreign grantor trust rules

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

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

Sale or exchange at market value

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

Other transfers

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

Transferors or beneficiaries who become U.S. persons

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

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

Treatment of former U.S. persons

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

Outbound trust migrations

The proposal would apply the rules of section 679 to a U.S. person that transferred property to a domestic trust if the trust subsequently became a foreign trust while the transferor was still alive. Such a person would be deemed to make a transfer to the foreign trust on the date of the migration. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally would be treated under the

rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. The proposal's reporting requirements and penalties (discussed below) also would be applicable.

Effective date

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

d. Residence of estates and trusts

Treatment as U.S. person

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

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

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

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

Outbound migration of domestic trusts

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

Effective date

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

e. Information reporting and penalties relating to foreign trusts

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

Information reporting requirements

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

Second, a U.S. person that is treated as the owner of any portion of a foreign trust would be required to ensure that the trust files an annual report to provide full accounting of all the trust activities for the taxable year, the name of the U.S. agent for the trust, and other information as prescribed by the Secretary of the Treasury.[41] In addition, unless a U.S. person is authorized to accept service of process as the trust's limited agent with respect to any request by the Treasury Department to examine records or to take testimony and any summons for such records or testimony in connection with the tax treatment of any items related to the trust, the Treasury Secretary would be entitled to determine, in its sole discretion, the amount to be taken into account under the grantor trust rules (secs. 671-679). This limited agency relationship would not constitute an agency relationship for any other purpose under Federal or State law.

Third, any U.S. person who receives (directly or indirectly) any distribution from a foreign trust would be required to file a notice to report the name of the trust, the aggregate amount of the distributions received, and other information that the Secretary of the Treasury may prescribe.

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

Monetary penalties for failure to report

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

Effective date

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

f. Reporting of certain foreign gifts

General rule

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

Effective date

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

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

Present Law

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

Description of Proposal

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

Effective Date

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

3. Taxation of certain captive insurance companies and their shareholders

Present Law

A deduction generally is allowed for insurance premiums incurred in connection with a taxpayer's trade or business. In contrast, no deduction is allowed for amounts set aside by the taxpayer to fund future losses.

An insurance company is defined under Treasury regulations as a company whose primary and predominant business activity is the issuance of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

The term "insurance" is not defined in the Code. In general, courts have held that an insurance transaction involves risk shifting and risk distribution. See *Helvering v. LeGierse*, 312 U.S. 531 (1941).

Under the subpart F rules, certain U.S. shareholders of a controlled foreign corporation (CFC) are required to include in income currently their shares of certain income of the CFC, whether or not such income is actually distributed to the shareholders. This current inclusion rule applies to certain insurance income of the CFC. In addition, special provisions under the subpart F rules apply to the related person insurance income of a CFC.

Premiums paid by a U.S. person to a foreign insurer or reinsurer with respect to the insurance of U.S. risks are subject to an excise tax, absent an applicable tax treaty that includes a waiver of this tax.

Description of Proposal

In general

Under the proposal, "disqualified shareholder insurance" would be treated as derived from a business other than insurance for purposes of determining whether the corporation qualifies as an insurance company under the primary and predominant business activity test of present law. In the case of a corporation that fails to qualify as an insurance company because of disqualified shareholder insurance (i.e., a disqualified corporation), premiums with respect to disqualified shareholder insurance would not be deductible when paid. Special rules (described below) would apply in determining the deductions and income inclusions of both the disqualified corporation and the insured with respect to disqualified shareholder insurance.

Disqualified shareholder insurance would be an insurance or reinsurance policy issued directly or indirectly with respect to a person who is a "large shareholder" of the issuing corporation, or a person related to such a shareholder. An insurance or reinsurance policy would not constitute disqualified shareholder insurance if the ultimate insured is not a large shareholder or a related person (e.g., a third-party risk that is reinsured by the issuing company's affiliate).

A large shareholder would be any person who owns or is considered as owning 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. For this purpose, the indirect and constructive ownership rules of section 958 would apply, other than section 958(b)(4). Policyholders of a mutual company would be treated as shareholders. A person would be considered to be related based on the application of rules similar to the rules of section 954(d)(3). Moreover, in the case of an insurance policy covering liability arising from services performed as a director, officer, or employee of a corporation or as a partner or employee of a partnership, the person performing such services would be treated as related to such corporation or partnership.

Treatment of disqualified corporation

Under the proposal, a disqualified corporation would not be subject to tax under subchapter L of the Code and would not be eligible for tax-exempt status under section 501(c)(15). The disqualified shareholder insurance generally would not constitute insurance for purposes of the Code.

The disqualified corporation would not include in income premiums for disqualified shareholder insurance. The disqualified corporation would include in income, in the year the insurance expires, the excess, if any, of the premiums received with respect to such insurance over the aggregate claims paid. The disqualified corporation could deduct the excess, if any, of the aggregate claims paid with respect to such insurance over the premiums received.

Treatment of large shareholder and related persons

Under the proposal, premiums paid to a disqualified corporation for disqualified shareholder insurance would not be deductible. Claims paid with respect to such disqualified shareholder insur-

ance would be includible in the income of the insured to the extent such aggregate payments exceed the premiums paid. The insured would be allowed a deduction, in the year the insurance expires, to the extent that the premiums with respect to such disqualified shareholder insurance exceed the aggregate claims paid. For purposes of section 165(a), the proceeds of such disqualified shareholder insurance would not constitute compensation by insurance or otherwise.

Application to reinsurance

For purposes of applying this proposal to arrangements involving reinsurance, premiums paid indirectly and claim amounts received indirectly would be taken into account. If any portion of disqualified shareholder insurance is ceded to a person that is not related to (1) the corporation that issued such insurance, (2) the ultimate insured with respect to such insurance, or (3) any related person, that portion would not constitute disqualified shareholder insurance.

Foreign personal holding company income

In the case of a foreign corporation that is a disqualified corporation, the proposal would create a new category of foreign personal holding company income under subpart F for income with respect to disqualified shareholder insurance. This new category of foreign personal holding income would consist of the excess, if any, of the amount of premiums received with respect to disqualified shareholder insurance over the claims paid with respect thereto.

Application of excise tax

Disqualified shareholder insurance would be treated as insurance for purposes of the insurance excise tax if the ultimate insured with respect to such disqualified shareholder insurance claims a deduction on its tax return for premiums paid directly or indirectly for such insurance.

Information reporting

Under the proposal, recordkeeping and information reporting requirements would apply in cases in which a corporation issues an insurance or reinsurance policy where the person directly or indirectly insured is a shareholder of the corporation or a person related to a shareholder. In such a case, the shareholder or the related person would be required to maintain records and provide information as prescribed in Treasury guidance. If any person fails to satisfy these requirements with respect to any insurance or reinsurance policy, no deduction would be allowed for premiums paid directly or indirectly by such person for such policy.

Regulatory authority

The Secretary of the Treasury would have authority to prescribe regulations as necessary or appropriate to carry out the purposes of the proposal. The Secretary could issue regulations (1) preventing avoidance of these rules through cross-insurance or multiple-contact arrangements or otherwise; (2) preventing items from being taken into account more than once; (3) providing that the deter-

mination of whether a corporation with disqualified shareholder insurance qualifies as an insurance company is made on the basis of the average of its net written premiums over multiple years; and (4) treating persons as related by reason of contractual arrangements or otherwise.

Effective Date

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

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

Present Law

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

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

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

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

Under section 1296, a foreign corporation is a passive foreign investment company ("PFIC") if the corporation satisfies either a passive income test or a passive assets test. Any U.S. person owning stock in a PFIC is subject to an interest charge with respect to cer-

tain distributions from the PFIC and gains on dispositions of the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes its share of the earnings of the PFIC. For this purpose, passive income is defined by reference to foreign personal company income.

Description of Proposal

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

An exception generally would be provided from foreign personal holding company income for certain items from transactions (including hedging transactions) entered into in the ordinary course of a CFC's business as a dealer in property, notional principal contracts, forward contracts, options and similar financial instruments (including instruments referenced to commodities).

Under the proposal, income, gain, deduction or loss from a notional principal contract entered into to hedge an item of income in another category of foreign personal holding company income would be allocated to that category.

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

Effective Date

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

5. Modification of foreign tax credit carryback and carryover periods

Present Law

A credit against U.S. tax on foreign source income is allowed for foreign taxes paid or accrued by a U.S. person. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The credit is limited to the taxpayer's pre-credit U.S. tax on its worldwide taxable income that is attributable to foreign source taxable income. The foreign tax credit limitation is calculated separately for specific categories of income (generally referred to as "separate limitation categories").

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 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 reduce from two years to one year the carryback period for excess foreign tax credits. The proposal also would extend the excess foreign tax credit carryforward period from five years to seven years.

Effective Date

The proposal would apply to foreign tax credits arising in taxable years beginning after December 31, 1996.

6. Modification of foreign tax credit rules applicable to dual capacity taxpayers

Present Law

Foreign tax credit

Creditability of foreign taxes

A credit against U.S. tax on foreign source income is allowed for foreign taxes paid or accrued by a U.S. person. The foreign tax credit is available only for income, war profits, and excess profits taxes paid or accrued (or deemed paid) to a foreign country or a U.S. possession and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses only.

Treasury regulations provide detailed rules for determining whether a foreign levy is a creditable tax. In general, a foreign levy is creditable only if the levy is a tax and its predominant character is that of an income tax in the U.S. sense. A levy is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country such as the right to extract petroleum owned by the foreign country. Under a safe harbor rule, a "dual capacity taxpayer" (i.e., a taxpayer that is subject to a foreign levy and receives a specific economic benefit from the levying country) may treat a portion of the levy paid to a foreign country as a tax even if the country does not otherwise impose a general tax (Treas. Reg. sec. 1.901-2A(e)).

Foreign tax credit limitation

The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The credit

is limited to the taxpayer's pre-credit U.S. tax on its worldwide taxable income that is attributable to foreign source taxable income. The foreign tax credit limitation is calculated separately for specific categories of income. Certain payments from a controlled foreign corporation ("CFC") to its 10-percent U.S. shareholders are subject to a look-thru rule which takes into account the extent to which the income of the payor is itself subject to one or more of these limitations (sec. 904(d)(3)). 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 to the extent that the taxpayer otherwise has excess foreign tax credit limitation for those years.

Under a special limitation, amounts claimed by a U.S. person as taxes paid or accrued on foreign oil and gas extraction income are creditable (provided that such amounts otherwise qualify as creditable) only to the extent that they do not exceed a special amount (e.g., 35 percent of such income in the case of a corporation) (sec. 907(a)). Excess foreign oil and gas extraction taxes created by this limitation may be carried back two years and forward five years. A taxpayer must have excess limitation under the special rules applicable to foreign extraction taxes and excess limitation under the general foreign tax credit provisions in order to utilize the excess foreign oil and gas extraction taxes in a carryback or carryforward year (sec. 907(f)(2)).

A taxpayer generally is required to recapture certain foreign oil and gas extraction losses incurred in a prior year. This rule converts income that would otherwise be foreign oil and gas extraction income into foreign source income that is not considered oil and gas extraction income (sec. 907(c)(4)). Because the character of the corresponding foreign oil and gas extraction taxes remains unchanged, the effect of the loss recapture rule is to produce a higher effective tax rate on foreign extraction income for taxpayers subject to the rule. Thus, such taxpayers are more likely to be subject to the special limitation imposed by section 907(a).

Subpart F

Absent applicable anti-deferral rules, a U.S. investor in a foreign corporation is subject to U.S. tax on the income of the foreign corporation when such income is distributed to him or her. However, anti-deferral rules apply with respect to the income of certain U.S.-owned foreign corporations (e.g., CFCs, passive foreign investment companies, and foreign personal holding companies). Under the subpart F rules (secs. 951-964), certain U.S. 10-percent shareholders of a CFC are subject to U.S. tax currently on their shares of certain income earned by the corporation (i.e., subpart F income), regardless of whether such income is distributed.

Subpart F income includes foreign base company oil related income (sec. 954(g)). Foreign base company oil related income generally is foreign oil related income other than income derived from a source within a foreign country in connection with (1) oil or gas which was extracted from an oil or gas well located in such foreign country, or (2) oil, gas, or a primary product of oil or gas which is

sold by the foreign corporation or a related person for use or consumption within such country or is loaded in such country on a vessel or aircraft as fuel for such vessel or aircraft. Foreign base company oil related income does not include income of small oil producers (i.e., corporations whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

Description of Proposal

Foreign tax credit

Creditability of foreign taxes for dual capacity taxpayers

The proposal would deny the foreign tax credit with respect to all amounts paid or accrued (or deemed paid) to any foreign country or possession by a "dual capacity taxpayer" if the country does not impose a "generally applicable income tax." For this purpose, a dual capacity taxpayer would be a taxpayer that is subject to a levy of any foreign country or possession of the United States and that and receives, directly or indirectly, a specific economic benefit from such country or possession. A generally applicable income tax would be a tax that a foreign country or a U.S. possession imposes on the income derived from business activities conducted within that country or possession, provided that the tax has substantial application to persons who are not dual capacity taxpayers and persons who are citizens or residents of the foreign country or possession. If the foreign country imposes a generally applicable income tax, then the amount of foreign tax credit that could be available to a dual capacity taxpayer would not exceed the amount of the generally applicable income tax that is or would be applicable to such taxpayer. The proposal would not apply to the extent contrary to any treaty obligation of the United States.

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

Foreign tax credit limitation

The proposal would create a separate foreign tax credit limitation with respect to "foreign oil and gas income." For this purpose, foreign oil and gas income would include the items that qualify as foreign oil and gas extraction income or foreign oil related income under present law. The proposal would repeal the special section 907(f) carryover and carryforward rules applicable to excess foreign oil and gas extraction taxes; instead, such taxes would be subject to the general carryback and carryforward provisions that apply to all excess foreign tax credits (see discussion in item 5 above for the description of a proposal that would modify the foreign tax credit carryback and carryforward periods). The proposal also would repeal the loss recapture rule of section 907(c)(4).

Effective date.—The proposal generally would apply to taxable years beginning after the date of enactment. The proposal contains several transitional rules. First, pre-effective date foreign oil and gas extraction taxes could be carried forward to post-effective date years to reduce the U.S. tax on foreign oil and gas income, if such taxes are proven to be paid or accrued with respect to foreign oil and gas income (without regard to the limitations presently con-

tained in sec. 907(f)). Finally, the loss recapture rule of section 907(c)(4) would remain in effect for foreign oil and gas extraction losses arising in taxable years beginning on or before the date of enactment.

Subpart F

The proposal generally would treat foreign oil and gas extraction income and foreign oil related income as foreign oil and gas income which is subject to current U.S. taxation under the rules of subpart F (without regard to the exceptions presently contained in sec. 954(g)). The proposal would extend the foreign tax credit look-thru rule applicable to certain payments from a CFC to foreign oil and gas income includible in the income of certain 10-percent U.S. shareholders of the CFC.

Effective date.—The proposal would apply to taxable years of foreign corporations beginning after the date of enactment and to taxable years of U.S. shareholders ending with or within such years.

D. Accounting Provisions

1. Termination of suspense accounts for family farm corporations required to use accrual method of accounting

Present Law

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

A provision of the Revenue Act of 1987 ("1987 Act") requires a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where 50 percent or more of the stock of the corporation is held by one family (or in some limited cases, two or three families).

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

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

Description of Proposal

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

into income ratably over a 10-period, beginning with the first taxable year beginning after September 13, 1995.

Effective Date

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

2. Treatment of bad debt deductions of thrift institutions

Present Law and Background

Reserve method of accounting for bad debts of thrift institutions

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

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

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

debts under a "base year" rule allowed a thrift institution to claim a deduction for bad debts for an amount at least equal to the institution's actual losses that were incurred during the taxable year.

Bad debt methods of commercial banks

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

Recapture of bad debt reserves by thrift institutions

If a thrift institution becomes a commercial bank, or if the institution fails to satisfy the 60-percent qualified asset test, it is required to change its method of accounting for bad debts and, under proposed Treasury regulations,[42] is required to recapture its bad debt reserve. The percentage-of-taxable-income portion of the reserve generally is included in income ratably over a 6-taxable year period. The experience method portion of the reserve is not restored to income if the former thrift institution qualifies as a small bank. If the former thrift institution is treated as a large bank, the experience method portion of the reserve is restored to income ratably over a 6-taxable year period, or under the 4-year recapture method or the cut-off method described above.

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

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

In general, for financial accounting purposes, a corporation must record a deferred tax liability with respect to items that are deduct-

[42] Prop. Treas. Reg. sec. 1.593-13.

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

Description of Proposal

Repeal of section 593

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

Treatment of recapture of bad debt reserves

In general

A thrift institution required to change its method of computing reserves for bad debts would treat such change as a change in a method of accounting, initiated by the taxpayer, and having been made with the consent of the Secretary of the Treasury. Any section 481(a) adjustment required to be taken into account with respect to such change generally would be determined solely with respect to the "applicable excess reserves" of the taxpayer. The amount of applicable excess reserves would be taken into account ratably over a 6-taxable year period, beginning with the first taxable year beginning after the date of enactment, subject to the residential loan requirement described below. In the case of a thrift institution that becomes a "large bank" (as determined under sec. 585(c)(2)), the amount of the institution's applicable excess reserves generally would be the excess of (1) the balance of its reserves described in section 593(c)(1) (other than its supplemental reserve for losses on loans) as of the close of its last taxable year beginning before the date of enactment, over (2) the balance of such reserves as of the close of its last taxable year beginning before January 1, 1988 (i.e., the "pre-1988 reserves"). Similar rules would be provided for "small banks" and for small banks that subsequently become large banks. The pre-1988 reserves of a thrift institution would be restored to income ratably if the institution ceased to be a bank. A thrift institution that becomes a credit union would be not be

treated as a bank and any reserves required to be included in income by the credit union would be treated as unrelated trade or business income.

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

Residential loan requirement

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

The "base amount" of a taxpayer would mean the average of the principal amounts of the residential loans made by the taxpayer during the six most recent taxable years beginning before the date of enactment. At the election of the taxpayer, the base amount may be computed by disregarding the taxable years within that 6-year period in which the principal amounts of loans made during such years were highest and lowest.

Effective Date

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

3. Reform depreciation under the income forecast method

Present Law

Depreciation and amortization, in general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through allowances for depreciation or amortization. Depreciation deductions are allowed under section 167 and the amounts of such deductions are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168 for most tangible property. MACRS determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Intangible property generally is amortized under section 197, which applies a 15-year recovery period and the straight-line method to the cost of applicable property.

Treatment of film, video tape, and similar property

MACRS does not apply to certain property, including (1) any motion picture film, video tape, or sound recording or (2) any other

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

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

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

Description of Proposal

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

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

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

Finally, taxpayers that claim depreciation deductions under the income forecast method would be required to pay (or would receive) interest based on the recalculation of depreciation under a "look-back" method. The "look-back" method would be applied in any "recomputation year" by: (1) comparing depreciation deductions that had been claimed in prior periods to depreciation deductions that would have been claimed had the taxpayer used actual, rather than estimated, total income from the property; (2) determining the hypothetical overpayment or underpayment of tax based on this recalculated depreciation; and (3) applying the overpayment rate of section 6621 of the Code. Except as provided in regulations, a "recomputation year" would be the third and tenth taxable year after the taxable year the property was placed in service unless the actual income from the property for each period before the close of such years was within 10 percent of the estimated income from the property for such periods. The Secretary of the Treasury would have the authority to allow a taxpayer to delay the initial application of the look-back method where the taxpayer may be expected to have significant income from the property after the third taxable year after the taxable year the property was placed in service (e.g., the Secretary may exercise such authority where the depreciable life of the property is expected to be longer than three years). Property with an adjusted basis of $100,000 or less when the property was placed in service would not be subject to the look-back method.

The proposal would provide a simplified look-back method for pass-through entities.

Effective Date

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

4. Repeal lower of cost or market inventory accounting method

Present Law

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

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

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

Retail merchants may use the "retail method" in valuing ending inventory. Under the retail method, the total of the retail selling prices of goods on hand at year end is reduced to approximate cost by deducting an amount that represents the gross profit embedded in the retail prices. The amount of the reduction generally is determined by multiplying the retail price of goods available at yearend by a fraction, the numerator of which is the cost of goods available for sale during the year and the denominator of which is the total retail selling prices of the goods available for sale during the year, with adjustments for mark-ups and mark-downs (Treas. reg. sec. 1.471-8(a)). Under certain conditions, a taxpayer using the FIFO method may determine the approximate cost or market of inventory by not taking into account retail price mark-downs for the goods available for sale during the year, even though such mark-downs are reflected in the retail selling prices of the goods of goods on hand at year end (Treas. reg. sec. 1.471-8(d)). As a result, such

taxpayer may write down the value of inventory below both its cost and its market value.

Description of Proposal

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

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment. Any section 481(a) adjustment required to be taken into account pursuant to the change of method of accounting under the proposal would be taken into account ratably over a four taxable year period beginning with the first taxable year following the year the taxpayer is required to change its method of accounting.

5. Repeal components of cost inventory accounting method

Present Law

Taxpayers using the LIFO method to account for inventories may use the "dollar-value" LIFO method. Under the dollar-value LIFO method, inventory items are expressed in terms of constant dollars and "base-year" costs (rather than units), and are grouped in inventory pools. Total base-year costs by pool, rather than the quantity of specific goods, are used to measure inventory increases and decreases. If ending inventory at base-year costs is greater than beginning inventory at base-year costs (i.e., there has been an increase in inventory), such increase is valued at current-year costs. Taxpayers define items in the pool under the "total product cost" ("TPC") method or the "components of cost" ("COC") method. Under the TPC method, ending inventory is determined by valuing the items in ending inventory by the base-year cost of producing such items. Under the COC method, taxpayers do not measure ending inventory with reference to the total product cost of producing the items in ending inventory, but rather treat the units of production (i.e., the amount of material, labor, and overhead) that were used to produce the inventory as separate items.

The proper application of the COC method to labor and overhead is unclear under present law.[43] Accordingly, the COC method as applied by some taxpayers may produce different results than the TPC method whenever a taxpayer's production processes change between the base year and the current year. For example, assume

[43] The use of the COC method as applied by some taxpayers with respect to labor and overhead costs is not specifically provided for in the Code or regulations, but such method may be used for financial accounting purposes. Treasury regulations allow taxpayers to treat raw materials (and the raw material content of work-in-process and finished goods) as a separate item under the LIFO method (Treas. Reg. sec. 1.472-1(c)). The Internal Revenue Service ("IRS") has ruled under the particular facts and circumstances of one taxpayer that the application of the COC method by that taxpayer did not clearly reflect income (TAM 9405005).

that in the base year the taxpayer can produce an item by applying 5 units of material at $8 a unit, 10 hours of direct labor at $10 an hour, and 10 hours of overhead at $5 an hour.[44] Thus, it costs $190 to produce an item in the base year (5 times $8, plus 10 times $10, plus 10 times $5). Further assume that: (1) the taxpayer's production processes change such that in the current year it now takes 5 units of materials, 5 hours of direct labor, and 5 hours of overhead to produce the same item; (2) the prices for materials, labor, and overhead have remained constant from the base year to the current year; and (3) one item of inventory remains at the end of the current year. Under the TPC method, because prices have remained constant, ending inventory would be valued at $190 (the total product cost of producing one item in the base year). Under the COC method as applied by some taxpayers, ending inventory could be valued at $115 (5 units of materials times $8, plus 5 hours of direct labor times $10, plus 5 hours of overhead times $5).

Thus, in this example, application of the COC method in this manner would reduce taxable income by $75 ($190 less $115) in the current year as compared to the TPC method. The $75 reduction in taxable income is comprised of the following: (1) $50 of direct labor reductions (5 less direct labor hours times the $10 per hour labor rate) and (2) $25 of overhead reductions. In this case, the reduction in labor hours is demonstrable. However, the reduction in overhead results because of the use of the burden rate that allocates overhead based on direct labor hours rather than because of a demonstrable reduction of the appropriate amount of overhead to be applied to inventory. In fact, a reduction of labor hours in the current year may be attributable to an increased reliance upon overhead costs in the production process (e.g., reductions in workforce may result because of increased mechanization).

Description of Proposal

The proposal generally would repeal the COC method. Specifically, the proposal would allow a taxpayer to use a dollar-value method of pricing inventory only if labor and overhead are not treated as separate items and such costs for the base year are used whenever necessary to determine the reconstructed cost of an item.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment. For taxpayers continuing to use a LIFO method of valuing inventory, the proposal would be applied on a cut-off basis. For taxpayers switching to a FIFO or other method of valuing inventory, the proposal would be applied as if the change in the method of accounting was initiated by the taxpayer with the approval of the Secretary of the Treasury.

The proposal is not intended to affect the determination of whether the COC method is an appropriate method under present law and it is intended that the IRS would not be precluded from challenging its use in taxable years beginning on or before the date of enactment.

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[44] In this example, overhead is allocated to inventory pursuant to a burden rate based on direct labor hours. Such allocations are common.

E. Administrative Provisions

1. Repeal advance refunds of diesel fuel tax for diesel automobiles, vans, and light trucks

Present Law

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

Description of Proposal

The President's budget proposal would repeal the tax credit for purchasers of diesel-fuel-powered automobiles, vans, and light trucks.

Effective Date

The proposal would apply to vehicles purchased after the date of the proposal's enactment.

2. Increased information reporting penalties

Present Law

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

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

10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

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

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

Description of Proposal

The proposal would increase the penalty for failure to file information returns correctly on or before August 1 from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported correctly but not so reported. The $250,000 maximum penalty for failure to file correct information returns during any calendar year ($100,000 with respect to small businesses) would continue to apply under the proposal.

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

The proposal would not affect the following provisions of present law: (1) the reduction in the $50 penalty where correction is made within a specified period; (2) the exception for de minimis failures; (3) the lower limitations for persons with gross receipts of not more than $5,000,000; (4) the increase in the penalty in cases of intentional disregard of the filing requirement; (5) the penalty for failure to furnish correct payee statements under section 6722; (6) the penalty for failure to comply with other information reporting requirements under section 6723; and (7) the reasonable cause and other special rules under section 6724.

Effective Date

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

3. Reporting of certain payments made to attorneys

Present Law

Information reporting is required by persons engaged in a trade or business and making payments in the course of that trade or business of "rent, salaries, wages, ... or other fixed or determinable gains, profits, and income" (Code sec. 6041(a)). Treas. Reg. sec. 1.6041-1(d)(2) provides that attorney's fees are required to be reported if they are paid by a person in a trade or business in the course of a trade or business. Reporting is required to be done on Form 1099-Misc. If, on the other hand, the payment is a gross amount and it is not known what portion is the attorney's fee, no reporting is required on any portion of the payment.

Description of Proposal

The proposal would require gross proceeds reporting on all payments to attorneys made by a trade or business in the course of that trade or business. It is anticipated that gross proceeds reporting would be required on Form 1099-B (currently used by brokers to report gross proceeds). The only exception to this new reporting requirement would be for any payments reported on either Form 1099-Misc under section 6041 (reports of payment of income) or on Form W-2 under section 6051 (payments of wages).

In addition, the present exception in the regulations exempting from reporting any payments made to corporations would not apply to payments made to attorneys. Treas. Reg. sec. 1.6041-3(c) exempts payments to corporations generally (although payments to most corporations providing medical services must be reported). Reporting would be required under both Code sections 6041 and 6045 (as proposed) for payments to corporations that provide legal services. The exception of Treas. Reg. sec. 1.6041-3(g) exempting from reporting payments of salaries or profits paid or distributed by a partnership to the individual partners would continue to apply to both sections (since these amounts are required to reported on Form K-1).

First, the proposal would apply to payments made to attorneys regardless of whether the attorney is the exclusive payee. Second, payments to law firms are payments to attorneys, and therefore would be subject to this reporting provision. Third, attorneys would be required to promptly supply their TINs to persons required to file these information reports, pursuant to section 6109. Failure to do so could result in the attorney being subject to penalty under section 6723 and the payments being subject to backup withholding under section 3406. Fourth, the IRS should administer this provision so that there is no overlap between reporting under section 6041 and reporting under section 6045. For example, if two payments are simultaneously made to an attorney, one of which represents the attorney's fee and the second of which represents the settlement with the attorney's client, the first payment would be reported under section 6041 and the second payment would not be reported under either section 6041 or section 6045, since it is known that the entire payment represents the settlement with the

client (and therefore no portion of it represents income to the attorney).

Effective Date

The proposal would be effective for payments made after December 31, 1996. Consequently, the first information reports would be filed with the IRS (and copies will be provided to recipients of the payments) in 1998, with respect to payments made in 1997.

4. Application of failure-to-pay penalty to substitute returns

Present Law

Section 6651(a)(2) provides that the IRS may assess a penalty for failure to pay tax from the due date of the return until the tax is paid. If no return is filed by the taxpayer and the IRS files a substitute return under section 6020, the tax on which the penalty is measured is considered a deficiency assessable under section 6212 or 6213, and the failure to pay penalty begins to accumulate ten days after the IRS sends the taxpayer a notice and demand for payment of the tax.

Description of Proposal

The proposal would apply the failure to pay penalty to substitute returns in the same manner as the penalty applies to delinquent filers.

Effective Date

The proposal would apply in the case of any return the due date for which (determined without regard to extensions) is after the date of enactment.

5. Extension of withholding to certain gambling winnings

Present Law

In general, proceeds from a wagering transaction are subject to withholding at a rate of 28 percent if the proceeds exceed $5,000 and are at least 300 times as large as the amount wagered. The proceeds from a wagering transaction are determined by subtracting the amount wagered from the amount received. No withholding tax is imposed on winnings from bingo or keno.

Description of Proposal

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

Effective Date

The proposal would be effective on the date of enactment.

6. Information reporting on persons receiving contract payments from certain Federal agencies

Present Law

A service recipient (i.e., a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the IRS an information return reporting such payments (and the name, address, and taxpayer identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more (sec. 6041A(a)). A similar statement must also be furnished to the person to whom such payments were made (sec. 6041A(e)). Treasury regulations explicitly exempt from this reporting requirement payments made to a corporation (Treas. Reg. 1.6041A-1(d)(2)).

The head of each Federal executive agency must file an information return indicating the name, address, and taxpayer identification number (TIN) of each person (including corporations) with which the agency enters into a contract (sec. 6050M). The Secretary of the Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the returns useful as a source of information for collection purposes. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts. Treasury regulations provide that no reporting is required if the contract is for $25,000 or less (Treas. Reg. 1.6050M-1(c)(1)(i)).

Description of Proposal

The proposal would require reporting of all payments of $600 or more made by a Federal executive agency to any person (including a corporation) for services. In addition, the proposal would require that a copy of the information return be sent by the Federal agency to the recipient of the payment. An exception would be provided for certain classified or confidential contracts.

Effective Date

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

7. Disclosure of returns on cash transactions

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the IRS to another agency unless the other agency establishes procedures satisfactory

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to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Under section 6050I, any person who receives more than $10,000 in cash in one transaction (or two or more related transactions) in the course of a trade or business generally must file an information return (Form 8300) with the IRS specifying the name, address, and taxpayer identification number of the person from whom the cash was received and the amount of cash received.

The Anti-Drug Abuse Act of 1988 provided a special rule permitting the IRS to disclose these information returns to other Federal agencies for the purpose of administering Federal criminal statutes. The special rule originally was to expire after November 18, 1990, and was extended by the Comprehensive Crime Control Act of 1990 to November 18, 1992.

Description of Proposal

The proposal would permanently extend the special rule for disclosing Form 8300 information. Moreover, the proposal would permit disclosures not only to Federal agencies but also to State, local and foreign agencies and for civil, criminal and regulatory purposes (i.e., generally in the same manner as Currency Transaction Reports filed by financial institutions under the Bank Secrecy Act). Disclosure, however, would not be permitted to any such agency for purposes of tax administration. The proposal would also (1) extend the dissemination policies and guidelines under section 6103 to people having access to Form 8300 information, and (2) apply section 6103 sanctions to persons having access to Form 8300 information that disclose this information without proper authorization.

Effective Date

The proposal would be effective on the date of enactment.

8. Extension of authority for IRS undercover operations

Present Law

The Anti-Drug Abuse Act of 1988 exempted IRS undercover operations from the otherwise applicable statutory restrictions controlling the use of Government funds (which generally provide that all receipts be deposited in the general fund of the Treasury and all expenses be paid out of appropriated funds). In general, the exemption permits the IRS to "churn" the income earned by an undercover operation to pay additional expenses incurred in the undercover operation. The IRS is required to conduct a detailed financial audit of large undercover operations in which the IRS is churning funds and to provide an annual audit report to the Congress on all such large undercover operations. The exemption originally expired on December 31, 1989, and was extended by the Comprehensive Crime Control Act of 1990 to December 31, 1991. The IRS has not had the authority to churn funds from its undercover operations since 1991.

Description of Proposal

The proposal would reinstate for five years (from the date of enactment through December 31, 2000) the IRS's offset authority under section 7608(c). The proposal would amend the IRS annual reporting requirement under section 7608(c)(4)(B) to require the provision of the following data: (1) the date the operation was initiated; (2) the date offsetting was approved; (3) the total current expenditures and the amount and use of proceeds of the operation; (4) a detailed description of the undercover operation projected to generate proceeds, including the potential violation being investigated, and whether the operation is being conducted under grand jury auspices; and (5) the results of the operation to date, including the results of criminal proceedings.

Effective Date

The proposal would be effective on the date of enactment.

9. Disclosure of tax return information for administration of certain veterans programs

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service (IRS) to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs (DVA) of self-employment tax information and certain tax information supplied to the Internal Revenue Service and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA.

The DVA is required to comply with the safeguards currently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

The DVA disclosure provision is scheduled to expire after September 30, 1998.

Description of Proposal

The proposal would extend the DVA disclosure provision through September 30, 2002.

Effective Date

The proposal would be effective on the date of enactment.

10. Extension of IRS user fees

Present Law

The Internal Revenue Service ("IRS") provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. The Uruguay Round Agreements Act extended the IRS user fee program for five years (until October 1, 2000).[45]

Description of Proposal

The IRS user fees would be extended for two additional years (until October 1, 2002).

Effective Date

The proposal would be effective on the date of enactment.

[45] A 3-year extension, until October 1, 2003, is included in Pub. L. No. 104-117 (H.R. 2778) (providing tax benefits for individuals performing services in Bosnia and certain other hazardous duty areas), as signed by the President on March 20, 1996.

F. Casualty and Involuntary Conversion Provisions

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

Present Law

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified replacement period of time. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion. In cases in which a taxpayer purchases stock as replacement property, the taxpayer generally reduces the basis of the stock, but does not reduce the basis of the underlying assets. Thus, the reduction in the basis of the stock generally does not result in reduced depreciation deductions where the corporation holds depreciable property, and may result in the taxpayer having more aggregate depreciable basis after the acquisition of replacement property than before the involuntary conversion.

Description of Proposal

The proposal would provide that where the taxpayer satisfies the replacement property requirement of section 1033 by acquiring stock in a corporation, the corporation generally will reduce its adjusted bases in its assets by the amount by which the taxpayer reduces its basis in the stock. The corporation's adjusted bases in its assets would not be reduced, in the aggregate, below the taxpayer's basis in its stock (determined after the appropriate basis adjustment for the stock). In addition, the basis of any individual asset would not be reduced below zero. The basis reduction would be first applied to: (1) property that is similar or related in service or use to the converted property, then (2) to other depreciable property, then (3) to other property.

Effective Date

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

2. Expansion of requirement that involuntarily converted property be replaced with property from an unrelated person

Present Law

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the

converted property within a specified replacement period of time. Pursuant to a provision of H.R. 831, as passed by the Congress and signed by the President on April 11, 1995 (P.L.104-7), subchapter C corporations (and certain partnerships with corporate partners) are not entitled to defer gain under section 1033 if the replacement property or stock is purchased from a related person.

Description of Proposal

The proposal would expand the present-law denial of the application of section 1033 to any other taxpayer (including an individual) that acquires replacement property from a related party (as defined by secs. 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of $100,000 or less for the taxable year with respect to converted property with aggregate realized gains. In the case of a partnership (or S corporation), the annual $100,000 limitation would apply to both the partnership (or S corporation) and each partner (or shareholder).

Effective Date

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

G. Excise Tax on Amounts of Private Excess Benefits

Present Law

Private inurement

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

Social welfare organizations.—A tax-exempt social welfare organization described in section 501(c)(4) must be organized on a non-profit basis and must be operated exclusively for the promotion of social welfare. In contrast to section 501(c)(3), however, there is no specific statutory rule in section 501(c)(4) prohibiting the net earnings of a social welfare organization described in section 501(c)(4) from inuring to the benefit of a private shareholder or individual.[46]

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

Sanctions for private inurement and other violations of exemption standards

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

Filing and public disclosure rules

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return (Form 990) with the Internal Revenue Service ("IRS"), setting forth the organization's items of gross income and expenses attributable to such income, disbursements for tax-exempt purposes, plus certain other information for the taxable year. Private foundations are required to allow public inspection at the foundation's principal office of their current annual information return. Other tax-exempt organizations, including public charities, are required to allow pub-

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

lic inspection at the organization's principal office (and certain regional or district offices) of their annual information returns for the three most recent taxable years (sec. 6104(e)). The Code also requires that tax-exempt organizations allow public inspection of the organization's application to the IRS for recognition of tax-exempt status, the IRS determination letter, and certain related documents. In addition, upon written request to the IRS, members of the general public are permitted to inspect annual information returns of tax-exempt organizations and applications for recognition of tax-exempt status (and related documents) at the National Office of the IRS in Washington, D.C. A person making such a written request is notified by the IRS when the material is available for inspection at the National Office, where notes may be taken of the material open for inspection, photographs taken with the person's own equipment, or copies of such material obtained from the IRS for a fee (Treas. Reg. secs. 301.6104(a)-6 and 301.6104(b)-1).

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

Description of Proposal

Extend private inurement prohibition to social welfare organizations

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

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

Effective date.—This provision generally would be effective on September 14, 1995. However, under a special transition rule, the provision would not apply to inurement occurring prior to one year after the date of enactment, if such inurement results from a writ-

ten contract that was binding on September 13, 1995, and at all times thereafter before such inurement occurred, and the terms of which have not materially changed.

Intermediate sanctions for excess benefit transactions

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

An "excess benefit transaction" would be defined as: (1) any transaction in which an economic benefit is provided to, or for the use of, any disqualified person if the value of the economic benefit provided directly by the organization (or indirectly through a controlled entity[47]) to such person exceeds the value of consideration (including performance of services) received by the organization for providing such benefit; and (2) to the extent provided in Treasury Department regulations, any transaction in which the amount of any economic benefit provided to, or for the use of, any disqualified person is determined in whole or in part by the revenues of the organization, provided that the transaction constitutes prohibited inurement under present-law section 501(c)(3) or under section 501(c)(4), as amended. Thus, "excess benefit transactions" subject to excise taxes would include transactions in which a disqualified person engages in a non-fair-market-value transaction with an organization or receives unreasonable compensation, as well as financial arrangements (to the extent provided in Treasury regulations) under which a disqualified person receives payment based on the organization's income in a transaction that violates the present-law private inurement prohibition. The Treasury Department would be instructed to issue prompt guidance providing examples of revenue-sharing arrangements that violate the private inurement prohibition, and such guidance would be applicable on a prospective basis.[48]

Existing tax-law standards (see sec. 162) would apply in determining reasonableness of compensation and fair market value.[49] In applying such standards, it is intended that the parties to a transaction would be entitled to rely on a rebuttable presumption of reasonableness with respect to a compensation arrangement with a

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

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

[49] In this regard, the conferees intend that an individual need not necessarily accept reduced compensation merely because he or she renders services to a tax-exempt, as opposed to a taxable, organization. Cf. Treas. Reg. sec. 53.4941(d)-3(c)(1).

disqualified person if such arrangement was approved by a board of directors or trustees (or committee thereof) that: (1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement[50] ; (2) obtained and relied upon appropriate data as to comparability (e.g., compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys by nationally recognized independent firms; or actual written offers from similar institutions competing for the services of the disqualified person); and (3) adequately documented the basis for its determination (e.g., the record includes an evaluation of the individual whose compensation was being established and the basis for determining that the individual's compensation was reasonable in light of that evaluation and data).[51] If these three criteria are satisfied, penalty excise taxes could be imposed under the proposal only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction (e.g., the IRS could establish that the compensation data relied upon by the parties was not for functionally comparable positions or that the disqualified person, in fact, did not substantially perform the responsibilities of such position). A similar rebuttable presumption would arise with respect to the reasonableness of the valuation of property sold or otherwise transferred (or purchased) by an organization to (or from) a disqualified person if the sale or transfer (or purchase) is approved by an independent board that uses appropriate comparability data and adequately documents its determination. Legislative history would indicate the expectation that any guidance issued by the Secretary of the Treasury and IRS in connection with the reasonableness standard would incorporate this presumption.

The proposal would specifically provide that the payment of personal expenses and benefits to or for the benefit of disqualified persons, and non-fair-market-value transactions benefiting such persons, would be treated as compensation only if it is clear that the organization intended and made the payments as compensation for services. In determining whether such payments or transactions are, in fact, compensation, the relevant factors would include whether the appropriate decision-making body approved the transfer as compensation in accordance with established procedures and whether the organization and the recipient reported the transfer (except in the case of non-taxable fringe benefits) as compensation on the relevant forms (i.e., the organization's Form 990, the Form W-2 or Form 1099 provided by the organization to the recipient, the recipient's Form 1040, and other required returns).[52]

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[50] A reciprocal approval arrangement whereby an individual approves compensation of the disqualified person, and the disqualified person, in turn, approves the individual's compensation does not satisfy the independence requirement.

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

[52] With the exception of nontaxable fringe benefits described in present-law section 132 and other types of nontaxable transfers such as employer-provided health benefits and contributions

Consistent with the rule that payment of personal expenses and benefits to or for the benefit of disqualified persons and nonfair-market value transactions benefiting such persons are treated as compensation only if it is clear that the organization intended and made the payments as compensation for services, any reimbursements by the organization of excise tax liability would be treated as an excess benefit unless they are included in the disqualified person's compensation during the year the reimbursement is made. The total compensation package, including the amount of any reimbursement, would be subject to the reasonableness requirement. Similarly, the payment by an applicable tax-exempt organization of premiums for an insurance policy providing liability insurance to a disqualified person for excess benefit taxes would be an excess benefit transaction unless such premiums are treated as part of the compensation paid to such disqualified person.[53]

"Disqualified person" would mean any individual who is in a position to exercise substantial influence over the affairs of the organization, whether by virtue of being an organization manager or otherwise.[54] In addition, "disqualified persons" include certain family members and 35-percent owned entities[55] of a disqualified person, as well as any person who was a disqualified person at any time during the five-year period prior to the transaction at issue. A person having the title of "officer, director, or trustee" would not automatically have the status of a disqualified person.[56] In addition, the Secretary of Treasury would have authority to promulgate rules exempting broad categories of individuals from the category of "disqualified persons" (e.g., full-time bona fide employees who receive economic benefits of less than a threshold amount or persons who have taken a vow of poverty).

A disqualified person who benefits from an excess benefit transaction would be subject to a first-tier penalty tax equal to 25 percent of the amount of the excess benefit (i.e., the amount by which a transaction differs from fair market value, the amount of com-

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to qualified pension plans, an organization could not demonstrate at the time of an IRS audit that it clearly indicated its intent to treat economic benefits provided to a disqualified person as compensation for services merely by claiming that such benefits may be viewed as part of the disqualified person's total compensation package. Rather, the organization would be required to provide substantiation that is contemporaneous with the transfer of economic benefits at issue.

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

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

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

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

pensation exceeding reasonable compensation, or (under Treasury regulations) the amount of a prohibited transaction based on the organization's gross or net income). Organization managers who participate in an excess benefit transaction knowing that it is an improper transaction would be subject to a first-tier penalty tax of 10 percent of the amount of the excess benefit (subject to a maximum penalty of $10,000).[57]

Additional, second-tier taxes could be imposed on a disqualified person if there is no correction of the excess benefit transaction within a specified time period.[58] In such cases, the disqualified person would be subject to a penalty tax equal to 200 percent of the amount of excess benefit. For this purpose, the term "correction" would mean undoing the excess benefit to the extent possible and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.

The intermediate sanctions for "excess benefit transactions" could be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status.[59] If more than one disqualified person or manager is liable for a penalty excise tax, then all such persons would be jointly and severally liable for such tax. As under current law, a three-year statute of limitations would apply, except in the case of fraud (sec. 6501). Under the proposal, the IRS would have authority to abate the excise tax penalty (under present-law sec. 4962) if it is established that the violation was due to reasonable cause and not due to willful neglect and the transaction at issue was corrected within the specified period.

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

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

In addition, legislative history would indicate that parties to transactions entered into after September 13, 1995, and before one year after the date of enactment, would be entitled to rely on the

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

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

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

rebuttable presumption of reasonableness if, within a reasonable period (e.g., 90 days) after entering into the compensation package, the parties satisfy the three criteria that give rise to the presumption. After this period, the rebuttable presumption should arise only if the three criteria are satisfied *prior* to payment of the compensation (or, to the extent provided by the Secretary of the Treasury, within a reasonable period thereafter).

Additional filing and public disclosure rules

Reporting of information with respect to certain disqualified persons, excise tax penalties and excess benefit transactions.— Tax-exempt organizations would be required to disclose on their Form 990 such information with respect to disqualified persons as the Secretary of the Treasury may prescribe. Legislative history would indicate that this requirement is not intended to limit the Secretary's authority under section 6033(a)(1) to require information on annual returns filed by exempt organizations for the purpose of carrying out the internal revenue laws. In addition, exempt organizations would be required to disclose on their Form 990 such information as the Secretary of the Treasury may require with respect to "excess benefit transactions" (described above) and any other excise tax penalties paid during the year under present-law sections 4911 (excess lobbying expenditures), 4912 (disqualifying lobbying expenditures), or 4955 (political expenditures), including the amount of the excise tax penalties paid with respect to such transactions, the nature of the activity, and the parties involved.[60]

Furnishing copies of documents.—The proposal also would provide that a tax-exempt organization that is subject to the public inspection rules of present-law section 6104(e)(1) (i.e., any tax-exempt organization, other than a private foundation, that files a Form 990) is required to comply with requests made in writing or in person from individuals who seek a copy of the organization's Form 990 or the organization's application for recognition of tax-exempt status and certain related documents. Upon such a request, the organization is required to supply copies without charge other than a reasonable fee for reproduction and mailing costs. If so requested, copies must be supplied of the Forms 990 for any of the organization's three most recent taxable years. If the request for copies is made in person, then the organization must immediately provide such copies. If the request for copies is made in writing, then copies must be provided within 30 days. However, an organization could be relieved of its obligation to provide copies if, in accordance with regulations to be promulgated by the Secretary of Treasury, (1) the organization has made the requested documents widely available or (2) the Secretary of the Treasury determined, upon application by the organization, that the organization was subject to a harassment campaign such that a waiver of the obligation to provide copies would be in the public interest.

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

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

Penalties for failure to allow public inspection or provide copies.—The section 6652(c)(1)(C) penalty imposed on tax-exempt organizations that fail to allow public inspection or provide copies of certain annual returns or applications for exemption would be increased from the present-law level of $10 per day (with a maximum of $5,000) to $20 per day (with a maximum of $10,000). In addition, the section 6685 penalty for willful failure to allow public inspections or provide copies would be increased from the present-law level of $1,000 to $5,000.

Effective date.—The public inspection provisions governing tax-exempt organizations generally would apply to requests made no earlier than 60 days after the date on which Treasury publishes the anti-harassment regulations required under the proposal. The provisions regarding the reporting on annual returns of excise tax penalties and excess benefit transactions would be effective for returns with respect to taxable years beginning on or after the date of enactment.

H. Other Excise Taxes

1. Reinstate Superfund excise taxes and corporate environmental income tax

Present Law

Before January 1, 1996, four taxes were imposed to fund the Hazardous Substance Superfund Trust Fund ("Superfund") program:

(1) an excise tax on petroleum and imported refined products;

(2) an excise tax on certain hazardous chemicals;

(3) an excise tax on imported substances made with the chemicals subject to the tax in (2), above; and

(4) an income tax on corporations calculated using the alternative minimum tax rules.

Description of Proposal

The President's budget proposal would reinstate the three Superfund excise taxes during the period beginning on the date of the proposal's enactment and ending after September 30, 2006. The corporate environmental income tax would be reinstated for taxable years beginning after December 31, 1995, and before January 1, 2007.

Revenues from reinstatement of these taxes would be deposited in the Superfund Trust Fund.

Effective Date

The proposal would be effective on the date of enactment.

2. Reinstate Oil Spill Liability Trust Fund excise tax

Present Law

A 5-cents-per-barrel excise tax was imposed before January 1, 1995. Revenues from this tax were deposited in the Oil Spill Liability Trust Fund. The tax did not apply during any calendar quarter when the Treasury Department determined that the unobligated balance in this Trust Fund exceeded $1 billion.

Description of Proposal

The President's budget proposal would reinstate the Oil Spill Liability Trust Fund tax during the period beginning on the date of the proposal's enactment and ending after September 30, 2006. The proposal also would increase the $1 billion limit on the unobligated balance in this Oil Spill Liability Trust Fund to $2.5 billion.

Effective Date

The proposal would be effective on the date of enactment.

3. Reinstate Leaking Underground Storage Tank Trust Fund excise tax

Present Law

Before January 1, 1996, a 0.1-cent-per-gallon tax was imposed on all transportation motor fuels (other than propane and compressed natural gas) that were subject to the 4.3-cents-per-gallon deficit reduction fuels tax. In general, this tax applied to fuels used in highway, air (both commercial and noncommercial), rail, and inland waterway transportation.

Revenues from this tax were deposited in the Leaking Underground Storage Tank ("LUST") Trust Fund.

Description of Proposal

The President's budget proposal would reinstate the LUST excise tax during the period beginning on the date of the proposal's enactment and ending after September 30, 2006.

Revenues from reinstatement of the tax would be deposited in the LUST Trust Fund.

Effective Date

The proposal would be effective on the date of enactment.

4. Permanent extension of luxury excise tax on automobiles

Present Law

Present law imposes a 10-percent excise tax on that amount of an automobile's sales price in excess of $34,000. The $34,000 threshold is indexed for inflation. The tax is scheduled to expire after December 31, 1999.

Description of Proposal

The proposal would extend the 10-percent luxury excise tax on automobiles permanently.

Effective Date

The proposal would be effective on the date of enactment.

5. Reinstate Airport and Airway Trust Fund excise taxes

Present Law

Before January 1, 1996, the following excise taxes were imposed to fund the Airport and Airway Trust Fund program:

(1) 10 percent of the amount paid for domestic passenger transportation;

(2) 6.25 percent of the amount paid for domestic freight transportation;

(3) $6 on international passenger departures;

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

(5) 15 cents per gallon on gasoline used in noncommercial aviation.[61]

Description of Proposal

The aviation excises taxes would be reimposed through September 30, 2006, at the same rates as in effect before January 1, 1996. Revenues from reinstatement of these taxes would be deposited in the Airport and Airway Trust Fund.

Effective Date

The reinstated excise taxes on air passenger transportation (including international departures) and freight waybills would apply to transportation beginning after the date of the proposal's enactment, but only with respect to amounts paid after that date.

The reinstated portion of noncommercial aviation fuels taxes would apply to fuel sold after the date of the proposal's enactment.

6. Kerosene taxed as diesel fuel

Present Law

Diesel fuel used as a transportation motor fuel generally is taxed at 24.3 cents per gallon.[62] This tax is collected on *all* diesel fuel upon removal from a pipeline or barge terminal unless the fuel is indelibly dyed and is destined for a nontaxable use. Diesel fuel also is commonly used as heating oil; diesel fuel used as heating oil is not subject to tax. Certain other uses also are exempt from tax, and some transportation uses (e.g., rail and intercity buses) are taxed at reduced rates. Both exemptions and reduced-rates are realized through refund claims if undyed diesel fuel is used in a qualifying use.

Non-gasoline aviation fuel (both commercial and noncommercial use) currently is taxed at a rate of 4.3 cents per gallon. Before January 1, 1996, this aviation fuel was taxed at rates of 4.4 cents per gallon (commercial aviation) and 21.9 cents per gallon (noncommercial aviation). The expired portions of the pre-1996 rates consist of a 0.1-cent-per-gallon rate on both commercial and noncommercial aviation fuel that funded the Leaking Underground Storage Tank Trust Fund, and a 17.5-cents-per-gallon rate on noncommercial aviation fuel that funded the Airport and Airway Trust Fund. Separate provisions of the President's budget proposal would reinstate both of those expired tax rates. The tax on non-gasoline aviation fuel is imposed on the sale of the fuel by a "producer," typically a wholesale distributor. Thus, this tax is imposed at a point in the fuel distribution chain subsequent to removal from a terminal facility.

Kerosene is used both as a transportation fuel and as an aviation fuel. Kerosene also is blended with diesel fuel destined both for taxable (highway) and nontaxable (heating oil) uses to, among other

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[61] Fourteen cents per gallon of this tax continues to be imposed, with the revenues being deposited in the Highway Trust Fund. The proposal would transfer these revenues to the Airport and Airway Trust Fund.

[62] Before January 1, 1996, this tax rate was 24.4 cents per gallon. The additional 0.1 cent per gallon funded the Leaking Underground Storage Tank ("LUST") Trust Fund. Another provision of the President's budget proposal would reinstate that additional 0.1-cent-per-gallon tax.

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things, prevent gelling of the diesel fuel in cold temperatures. Under present law, kerosene is not subject to tax unless it is blended with taxable diesel fuel or is sold for use as aviation fuel. When kerosene is blended with dyed diesel fuel to be used in a nontaxable use, the dye concentration of the fuel mixture must be adjusted to ensure that it meets Treasury Department requirements for untaxed, dyed diesel fuel.

Clear, low-sulphur kerosene (K-1) also is used in space heaters, and often is sold for this purpose at retail service stations. As with other heating oil uses, kerosene used in space heaters, is not subject to Federal excise tax.

Description of Proposal

Subject to certain modifications, the President's budget proposal would extend the diesel fuel excise tax rules to kerosene. Under these rules, kerosene would be subject to tax when it was removed from a terminal facility unless the kerosene (1) was indelibly dyed and destined for a nontaxable use, (2) was aviation grade kerosene removed by a registered aviation dealer for sale or use as aviation fuel, (3) was received by pipeline or barge by a registered user for a non-fuel, feedstock use, or (4) subject to Treasury Department registration and other procedures, was removed or entered for a non-fuel feedstock use by the person removing the kerosene or the first purchaser from that person.

To accommodate State safety regulations requiring that only undyed K-1 kerosene be used in certain unvented space heaters, the current procedure allowing ultimate vendors of diesel fuel sold for nontaxable use by States and local governments and farmers to claim refunds would be extended to vendors selling kerosene for heating use from pumps not suitable for serving highway vehicles. In addition, the Treasury Department would be authorized develop procedures allowing vendor refunds under these rules for limited periods when extreme cold weather conditions in defined geographic areas require unanticipated addition of kerosene to consumer heating oil storage tanks.

Effective Date

The proposal would be effective for kerosene removed from terminal facilities after June 30, 1997. Appropriate floor stocks taxes would be imposed on kerosene held beyond the point of taxation on July 1, 1997.

I. Employment Taxes

1. Extension of Federal unemployment tax

Present Law

The Federal Unemployment Tax Act (FUTA) imposes a 6.2 percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2 percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States are supposed to use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

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

Description of Proposal

The proposal would extend the temporary surtax rate through December 31, 2006.

Effective Date

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

2. Deposit requirement for Federal unemployment taxes

Present Law

If an employer's liability for FUTA taxes is over $100 for any quarter, it must be deposited by the last day of the first month after the end of the quarter. Smaller amounts are subject to less frequent deposit rules.

Description of Proposal

The proposal would require an employer to pay Federal and State unemployment taxes on a monthly basis in a given year if the employer's FUTA tax liability in the prior year was $1,100 or more. The deposit with respect to wages paid during a month would be required to be made by the last day of the following month. A safe harbor would be provided for the required deposits for the first two months of each calendar quarter. For the first month in each quarter, the payment would be required to be the lesser of 30 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the month. The cumulative deposits paid in the first two months of each quarter would

be required to be the lesser of 60 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the two months. The employer would be required to pay the balance of the actual FUTA liability for each quarter by the last day of the month following the quarter. States would be required to establish a monthly deposit mechanism but would be permitted to adopt a similar safe harbor mechanism for paying State unemployment taxes.

Effective Date

The proposal would be effective for months beginning after December 31, 2001.

J. Other Individual Income Tax Provisions

1. Disallow rollover or exclusion of gain on sale of principal residence to the extent of previously claimed depreciation for home office or other depreciable use of residence

Present Law

Rollover

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

One-time exclusion

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

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

Description of Proposal

Rollover

The proposal would provide that gain is recognized on the sale of a principal residence to the extent of any depreciation allowable with respect to such principal residence for periods after December 31, 1996.

One-time exclusion

The proposal would impose an additional restriction on the availability of the one-time exclusion. Specifically, the proposal would provide that the amount of the otherwise allowable one-time exclusion is reduced and therefore the amount of recognized gain is increased to the extent of depreciation allowable with respect to such principal residence for periods after December 31, 1996. The proposal would not change the amount of the allowable depreciation or the gain recognition treatment on the rental portion of the building under present law.

Effective Date

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

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

Present Law

In general

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

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

Mathematical or clerical errors

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

Description of Proposal

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

Effective Date

The proposal would be effective for tax returns for which the due date (without regard to extensions) is more than 30 days after the date of enactment.

K. Earned Income Credit Provisions

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

Present Law

In general

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

The parameters for the credit depend upon the number of qualifying children the individual claims. For 1996, the parameters are given in the following table:

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

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

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

To satisfy the identification test, individuals must include on their tax return the name and age of each qualifying child. For returns filed with respect to tax year 1996, individuals must provide a taxpayer identification number (TIN) for all qualifying children born on or before November 30, 1996. For returns filed with respect

to tax year 1997 and all subsequent years, individuals must provide TINs for all qualifying children, regardless of their age. An individual's TIN is generally that individual's social security number.

Mathematical or clerical errors

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

Description of Proposal

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

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

Effective Date

The proposal would be effective for tax returns for which the due date (without regard to extensions) is more than 30 days after the date of enactment.

2. Change test for disqualified income

Present Law

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

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

Description of Proposal

For purposes of the disqualified income test, the following items would be added to the definition of disqualified income: capital gain net income and net passive income (if greater than zero) that is not self-employment income.

The threshold above which an individual would not be eligible for the credit would be reduced from $2,350 to $2,200, and the threshold would be indexed for inflation after 1996.

Effective Date

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

3. Modify definition of adjusted gross income used for phasing out the credit

Present Law

For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phaseout range, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

Description of Proposal

The President's budget proposal would modify the definition of AGI used for phasing out the credit by disregarding certain losses. The losses disregarded would be:

(1) net capital losses (if greater than zero),
(2) net losses from trusts and estates,
(3) net losses from nonbusiness rents and royalties, and
(4) 50 percent of the net loss from businesses, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.

For purposes of item (4), amounts attributable to a business that consist of the performance of services by the taxpayer as an employee would not be taken into account.

Effective Date

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

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

Present Law

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

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

Description of Proposal

In general

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

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

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

vance payment would be reduced by a percentage that equals the ratio of the excess to the aggregate amount of advance credit payments by the State agency.

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

Demonstration programs

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

In order to be eligible for selection as a demonstration program, a State would have to submit a proposal to the Treasury on or before June 30, 1998. That proposal would have to identify the State agency responsible for making the advanced payments; describe how the agency would make the advanced payments, including how they would be coordinated with other benefits; describe how the State would get information on the amount of advance payments made to each participant; describe the process to select and notify participants for the demonstration program; and describe how the State would verify participants' eligibility for the credit. The proposal would commit the State to providing to the IRS and the participant by each January 31 information returns showing the participant's name, taxpayer identification number (TIN), and amount of advance payments of credit for the preceding calendar year. The proposal would commit the State to providing a written statement to the IRS each December 1 showing the name and TIN of each participant.

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

Authorization of appropriation

For purposes of providing technical assistance, writing reports, and providing grants to States in support of demonstration programs, there would be authorized to be appropriated in advance to the Secretary of the Treasury and the Secretary of Health and Human Services a total of $1,400,000 for fiscal years 1999 through 2002.

Effective Date

The selection of demonstration programs would be made no later than December 31, 1998. The demonstration programs would be effective for credit advance payments made after December 31, 1998, and before January 1, 2002.

VI. HAZARDOUS DUTY AREA INCOME

1. Treatment of certain individuals performing services in certain hazardous duty areas

Present Law

General time limits for filing tax returns

Present law provides that individuals generally must file their Federal income tax returns by April 15 of the year following the close of a taxable year (sec. 6072). Present law also provides that the Secretary may grant reasonable extensions of time for filing such returns (sec. 6081). Treasury regulations provide an additional automatic two-month extension (until June 15 for calendar-year individuals) for United States citizens and residents in military or naval service on duty outside the United States (Treas. Reg. sec. 1.6081-5(a)(6)). No action is necessary to apply for this extension. This extension applies to both filing returns and paying the tax due.

Treasury regulations also provide, upon application on the proper form, an automatic four-month extension (until August 15 for calendar-year individuals) for any individual properly filing that form (Treas. Reg. sec. 1.6081-4T).

In general, individuals must make quarterly estimated tax payments by April 15, June 15, September 15, and January 15 of the following taxable year. Wage withholding is considered to be a payment of estimated taxes.

Suspension of time periods

In general, present law suspends the period of time for performing various acts under the Internal Revenue Code, such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax, for any individual serving in the Armed Forces of the United States in an area designated as a "combat zone" during the period of combatant activities (sec. 7508). An individual who becomes a prisoner of war is considered to continue in active service and is therefore also eligible for these suspension of time provisions. The suspension of time also applies to an individual serving in support of such Armed Forces in the combat zone, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the Armed Forces in support of those Forces. The designation of a combat zone must be made by the President in an Executive Order. The President also designates the period of combatant activities in the combat zone (the starting date and the termination date of combat).

The suspension of time encompasses the period of service in the combat zone during the period of combatant activities in the zone. In addition, it encompasses any time of continuous hospitalization resulting from injury received in the combat zone[63] or time in missing in action status, plus the next 180 days.

[63] Two special rules apply to continuous hospitalization inside the United States. First, the suspension of time provisions based on continuous hospitalization inside the United States are applicable only to the hospitalized individual; they are not applicable to the spouse of such individual. Second, in no event do the suspension of time provisions based on continuous hospitaliza-

Continued

The suspension of time applies to the following acts:

(1) Filing any return of income, estate, or gift tax (except employment and withholding taxes);

(2) Payment of any income, estate, or gift tax (except employment and withholding taxes);

(3) Filing a petition with the Tax Court for redetermination of a deficiency, or for review of a decision rendered by the Tax Court;

(4) Allowance of a credit or refund of any tax;

(5) Filing a claim for credit or refund of any tax;

(6) Bringing suit upon any such claim for credit or refund;

(7) Assessment of any tax;

(8) Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

(9) Collection of the amount of any liability in respect of any tax;

(10) Bringing suit by the United States in respect of any liability in respect of any tax; and

(11) Any other act required or permitted under the internal revenue laws specified in regulations prescribed under section 7508 by the Secretary of the Treasury.

Individuals may, if they choose, perform any of these acts during the period of suspension.

Spouses of qualifying individuals are entitled to the same suspension of time, except that the spouse is ineligible for this suspension for any taxable year beginning more than two years after the date of termination of combatant activities in the combat zone.

Exclusion for combat pay

Gross income does not include certain combat pay of members of the Armed Forces (sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income. In addition, if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone, military pay for that month is also excluded from gross income; this exclusion is limited, however, to hospitalization during any part of any month beginning not more than two years after the end of combat in the zone. In the case of commissioned officers, these exclusions from income are limited to $500 per month of military pay.

Income tax withholding does not apply to military pay for any month in which an employee (whether enlisted personnel or commissioned officer) is entitled to the exclusion from income for combat pay (sec. 3401(a)(1)).

Exemption from tax upon death in a combat zone

An individual in active service as a member of the Armed Forces who dies while serving in a combat zone (or as a result of wounds, disease, or injury received while serving in a combat zone) is not subject to income tax for the year of death (as well as for any prior taxable year ending on or after the first day the individual served in the combat zone) (sec. 692). Special computational rules apply in

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tion inside the United States extend beyond five years from the date the individual returns to the United States. These two special rules do not apply to continuous hospitalization outside the United States.

the case of joint returns. A reduction in estate taxes is also provided with respect to individuals dying under these circumstances (sec. 2201).

Special rules permit the filing of a joint return where a spouse is in missing status as a result of service in a combat zone (sec. 6013(f)(1)). Special rules for determining surviving spouse status apply where the deceased spouse was in missing status as a result of service in a combat zone (sec. 2(a)(3)).

Exemption from telephone excise tax

The telephone excise tax is not imposed on "any toll telephone service" that originates in a combat zone (sec. 4253(d)).

Operation Desert Storm: Executive Order designating Persian Gulf Area as a combat zone

On January 21, 1991, President Bush signed Executive Order 12744, designating the Persian Gulf Area as a combat zone. This designation was retroactive to January 17, 1991, the date combat commenced in that area, and continues in effect until terminated by another Executive Order. An Executive Order terminating this combat zone designation has not been issued. Thus, individuals serving in the Persian Gulf Area are eligible for the suspension of time provisions and military pay exclusions (among other provisions) described above, beginning on January 17, 1991.

The Executive Order specifies that the Persian Gulf Area is the Persian Gulf, the Red Sea, the Gulf of Oman, part of the Arabian Sea, the Gulf of Aden, and the entire land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates.

The Department of Defense provides to the Internal Revenue Service, on a monthly basis, a computer tape with information regarding the military personnel whose service is in the combat zone designated by the Executive Order and who are therefore eligible for, among other provisions, the extension of time provisions of section 7508 and the exclusion from income provisions of section 112.

Operation Desert Shield: Legislative extension of time

On January 30, 1991, President Bush signed Public Law 102-2. This Act amended section 7508 by providing that any individual who performs Desert Shield services (and the spouse of such an individual) is entitled to the benefits of the suspension of time provisions of section 7508. Desert Shield services are defined as services in the Armed Forces of the United States (or in support of those Armed Forces) if such services are performed in the area designated by the President as the "Persian Gulf Desert Shield area" and such services are performed during the period beginning August 2, 1990, and ending on the date on which any portion of the area was designated by the President as a combat zone pursuant to section 112 (which was January 17, 1991).

Operation Joint Endeavor: Administrative extension of time

On December 12, 1995, the Internal Revenue Service announced[64] that it was administratively extending the time to file tax returns until December 15, 1996, for members of the Armed Forces "departing 'Operation Joint Endeavor'" on or after March 1, 1996. In addition, the IRS stated that the penalties for failure to file tax returns and failure to pay taxes would not be assessed with respect to these individuals. Also, the IRS stated that it would administratively place any balance due accounts into suspense status and suspend examinations while the member is serving in "Operation Joint Endeavor."

Description of Proposal[65]

Treatment of portions of former Yugoslavia as if they were a combat zone

The proposal would provide that a qualified hazardous duty area shall be treated in the same manner as if it were a combat zone for purposes of the following provisions of the Code:

(1) the special rule for determining surviving spouse status where the deceased spouse was in missing status as a result of service in a combat zone (sec. 2(a)(3));

(2) the exclusions from income for combat pay (sec. 112);

(3) forgiveness of income taxes of members of the Armed Forces dying in the combat zone or by reason of combat-zone incurred wounds (sec. 692);

(4) the reduction in estate taxes for members of the Armed Forces dying in the combat zone or by reason of combat-zone incurred wounds (sec. 2201);

(5) the exemption from income tax withholding for military pay for any month in which an employee is entitled to the exclusion from income (sec. 3401(a)(1));

(6) the exemption from the telephone excise tax for toll telephone service that originates in a combat zone (sec. 4253(d));

(7) the special rule permitting filing of a joint return where a spouse is in missing status as a result of service in a combat zone (sec. 6013(f)(1)); and

(8) the suspension of time provisions (sec. 7508).

A qualified hazardous duty area would mean Bosnia and Herzegovina, Croatia, or Macedonia, if, as of the date of enactment, any member of the Armed Forces is entitled to hostile fire/imminent danger pay for services performed in such country. Members of the Armed Forces are in Bosnia and Herzegovina and Croatia as part of "Operation Joint Endeavor" (the NATO operation). Members of the Armed Forces are in Macedonia as part of "Operation Able Sentry" (the United Nations operation).

[64] Letter from John T. Lyons, Assistant Commissioner (International), Internal Revenue Service, to Lt. Col. David M. Pronchick, Armed Forces Tax Counsel, Department of Defense.

[65] The Administration's proposal is identical to Pub. L. No. 104-117 (H.R. 2778), as signed by the President on March 20, 1996.

Suspension of time provisions for other Operation Joint Endeavor personnel

An individual who is performing services as part of Operation Joint Endeavor outside the United States while deployed away from the individual's permanent duty station would qualify for the suspension of time provisions in section 7508 of the Code during the period that hostile fire/imminent danger pay is paid in Bosnia and Herzegovina, Croatia, or Macedonia.

Combat pay exclusion for officers

In addition, the proposal would raise the dollar value of the exclusion from income for combat pay for officers in section 112 of the Code from the present-law level of $500 per month to the highest rate of basic pay at the highest pay grade that enlisted personnel may receive plus the amount of hostile fire/imminent danger pay which the officer receives. Currently, the highest level of basic pay received by enlisted members of the Armed Forces is $4,104.80 per month. The proposal would also conform the wage withholding rules to the income exclusion rules for officers.

Effective Date

The proposal generally would be effective on November 21, 1995 (the date on which the Dayton Accord was initialed); the modifications to the wage withholding rules would apply to remuneration paid after the date of enactment.

VII. TAX CUT SUNSET

Present Law

The Internal Revenue Code has included sunsets of various specific tax provisions. Certain income tax provisions (e.g., sec. 127 exclusion for certain educational assistance programs, targeted jobs tax credit, research tax credit) expired in 1994 or 1995. Certain excise tax provisions (e.g., aviation excise taxes and Superfund excise taxes) expired in 1995. Also, Highway Trust Fund excise taxes are scheduled to expire after September 30, 1997.

Description of Proposal

The proposal would provide that certain provisions of the proposal would be sunset for taxable years beginning after December 31, 2000. The following provisions would be subject to the sunset: (1) credit for families with young children; (2) deduction for higher education expenses; (3) provisions relating to IRAs; (4) increase in self-employed individuals' deduction for health insurance costs; (5) increase in expensing for small businesses; and (6) expensing of environmental remediation costs ("brownfields"). The President has proposed that the affected tax cuts would be reinstated if the fiscal dividend for the year 2000, as determined under title II of the budget proposal, is at least $20 billion.

APPENDIX:
ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET PROPOSAL RELEASED ON MARCH 19, 1996

Fiscal Years 1997–2006

[Millions of Dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1997–01	1997–06
I. Middle Class Tax Relief													
A. Families With Children:													
1. Credit for families with young children[1]	tyba 12/31/95	−9,641	−7,925	−8,763	−12,509	−10,085	—	—	—	—	—	−48,923	−48,923
2. Deduction for higher education expenses[1]	pma 12/31/95	−6,746	−5,995	−6,679	−6,995	−4,532	—	—	—	—	—	−30,948	−30,948
B. Provisions Relating to Individual Retirement Plans[1]	1/1/96	−1,095	−635	−1,300	−2,166	−2,840	−2,754	−3,069	−3,405	−3,781	−3,954	−8,036	−24,999
Subtotal: Middle Class Tax Relief		**−17,482**	**−14,555**	**−16,742**	**−21,670**	**−17,457**	**−2,754**	**−3,069**	**−3,405**	**−3,781**	**−3,954**	**−87,907**	**−104,870**
II. Small Business Tax Relief													
1. Increase the self-employed health insurance deduction (35% in 1996 and 1997; 40% in 1998; 45% in 1999; and 50% in 2000)[1]	tyba 12/31/95	−119	−137	−267	−422	−358	—	—	—	—	—	−1,303	−1,303
2. Increase in expensing[1]	tyba 12/31/95	−603	−516	−623	−643	145	716	466	322	209	114	−2,240	−413
3. Modifications to estate tax extension provisions for closely held businesses	dda 12/31/96	—	−204	−234	−256	−281	−307	−289	−296	−299	−302	−975	−2,468
Subtotal: Small Business Tax Relief		**−722**	**−857**	**−1,124**	**−1,321**	**−494**	**409**	**177**	**26**	**−90**	**−188**	**−4,518**	**−4,184**
III. Pension Simplification Provisions													
A. Increased Access to Pension Plans:													
1. Establish National Employee Savings Trusts	yba 12/31/96	−58	−113	−158	−176	−194	−213	−234	−258	−283	−303	−699	−1,990

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET PROPOSAL RELEASED ON MARCH 19, 1996

Fiscal Years 1997–2006

[Millions of Dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1997–01	1997–06
2. Tax-exempt organizations and Indian tribes eligible under section 401(k)	yba 12/31/96	−8	−22	−24	−25	−26	−28	−29	−30	−31	−32	−106	−256
B. Simplified Distribution Rules:													
1. Sunset of 5-year income averaging for lump-sum distributions	tyba 12/31/98	24	74	63	94	65	56	31	17	—	—	319	423
2. Simplified method for taxing annuity distributions under certain employer plans	asda 12/31/96	10	28	28	29	29	29	30	30	31	31	124	275
3. Minimum required distributions	yba 12/31/96	−1	−4	−4	−4	−4	−4	−4	−4	−4	−4	−17	−37
C. Nondiscrimination Provisions:													
1. Simplified definition of highly compensated employees	yba 12/31/96	Considered in Other Provisions											
2. Repeal of family aggregation rules	yba 12/31/96	Considered in Other Provisions											
3. Modification of additional participation requirements .	yba 12/31/96	Negligible Revenue Effect											
4. Safe-harbor nondiscrimination rules for qualified cash or deferred arrangements and matching contributions	yba 12/31/98	—	—	−39	−146	−150	−154	−158	−164	−168	−170	−335	−1,149
5. Definition of compensation under section 415	yba 12/31/96	—	−1	−1	−2	−2	−2	−2	−2	−3	−3	−6	−18
6. Uniform retirement age	yba 12/31/96	Considered in Other Provisions											
D. Miscellaneous Pension Simplification:													
1. Plans covering self-employed individuals	yba 12/31/96	Negligible Revenue Effect											

Provision	Effective												
2. Elimination of special vesting rule for multiemployer plans	yba 12/31/96	(2)	-1	-1	-1	-1	-1	-1	-1	-1	-1	-4	-9
3. Distributions under rural cooperative plans	DOE	Negligible Revenue Effect											
4. Treatment of governmental plans under section 415	yba 12/31/95	Negligible Revenue Effect											
5. Treatment of multiemployer plans under section 415	yba 12/31/96	-1	-3	-3	-3	-4	-4	-4	-4	-5	-5	-14	-36
6. Excess benefit plans of tax-exempt organizations under section 457	yba 12/31/96	-16	-46	-48	-50	-53	-56	-58	-61	-64	-68	-213	-520
7. Contributions on behalf of disabled employees	yba 12/31/96	Negligible Revenue Effect											
8. Treatment of deferred compensation plans of State and local governments and tax-exempt organizations	tyba 12/31/96	—	(2)	-1	-1	-1	-1	-2	-2	-2	-2	-3	-12
9. Trust requirement for deferred compensation plans of State and local governments	DOE	(2)	-1	-1	-1	-1	-2	-2	-2	-2	-2	-4	-14
10. Repeal of certain GATT assumptions for adjusting certain early retirement benefits	eaii GATT	-6	-4	-4	—	—	—	—	—	—	—	-14	-14
11. Application of elective deferral limit to section 403(b) plans	tyba 12/31/96	Negligible Revenue Effect											
12. Repeal of combined plan limit	lyba 12/31/98	—	—	-70	-189	-195	-201	-207	-213	-219	-226	-454	-1,520
13. Increase section 4975 excise tax on prohibited transactions from 5% to 10%	ptoa DOE	1	4	4	4	4	4	4	4	4	4	17	37
14. Treatment of leased employees	yba 12/31/96	Negligible Revenue Effect											
15. Uniform penalty provisions	rda 12/31/96	Negligible Revenue Effect											
16. Full funding limit for multiemployer plans	yba 12/31/96	....	-3	-15	-15	-14	-14	-13	-13	-12	-12	-47	-111
17. Elimination of partial termination rules for multiemployer plans	ta 12/31/96	Negligilble Revenue Effect											
18. Elimination of half-year requirements	yba 12/31/96	31	17	5	6	7	8	9	10	11	12	66	116

APPENDIX:—Continued
ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET PROPOSAL RELEASED ON MARCH 19, 1996
Fiscal Years 1997–2006

[Millions of Dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1997–01	1997–06
19. Treatment of certain veterans' reemployment rights	12/12/94	No Revenue Effect											
20. Date for adoption of plan amendments	DOE	No Revenue Effect											
Subtotal: Pension Simplification Provisions (8)		**−24**	**−75**	**−269**	**−480**	**−540**	**−583**	**−640**	**−693**	**−748**	**−781**	**−1,390**	**−4,835**
IV. Empowerment Zones; Brownfields													
1. Designation of additional empowerment zones and enterprise communities; volume cap not to apply to enterprise zone facility bonds with respect to new empowerment zones; and modifications to enterprise zones facility bond rules for all empowerment zones and enterprise communities	(4)	−59	−121	−181	−206	−226	−238	−249	−242	−235	−223	−794	−1,981
2. Expensing of environmental remediation costs (1)	eia DOE	−102	−205	−248	−266	−108	5	15	28	40	52	−929	−789
Subtotal: Empowerment zones; Brownfields		**−161**	**−326**	**−429**	**−472**	**−334**	**−233**	**−234**	**−214**	**−195**	**−171**	**−1,723**	**−2,770**
V. Corporate Reform and Other Revenue Provisions													
A. Revision of Expatriation Tax Rules	2/6/95	41	63	97	139	181	216	247	275	298	322	521	1,879

B. Corporate Reforms:													
1. Basis of substantially identical securities determined on average basis	DOE + 30 days	388	379	369	360	351	342	334	325	317	309	1,847	3,474
2. Require recognition of gain on certain appreciated positions in personal property	(5)	321	100	63	68	73	79	85	91	98	105	625	1,083
3. Extend pro rata disallowance of tax-exempt interest expenses to all corporations	(6)	43	48	56	64	69	72	76	79	82	85	279	673
4. Deny interest deduction on certain debt instruments	dio/a 12/7/95	101	136	212	262	288	303	317	329	339	351	999	2,638
5. Interaction of #4. with #13	dia 12/7/95	4	5	8	11	12	12	13	13	14	15	40	107
6. Defer interest deduction on certain convertible debt	dio/a 12/7/95	21	36	53	64	78	90	101	108	116	123	252	790
7. Gains and losses from certain terminations with respect to property (extinguishment)	setomt 30 daDOE	15	25	25	25	25	25	25	25	25	25	115	240
8. Determination of original issue discount where pooled debt obligations subject to acceleration	tyba DOE	188	263	270	241	101	83	87	91	95	99	1,063	1,518
9. Gain recognition for certain extraordinary dividends	da 5/3/95	−65	−68	−30	10	66	101	110	120	129	141	−87	514
10. Recognition of gain in certain section 355 transactions	(7)	155	125	100	75	50	50	50	50	50	50	505	755
11. Tax treatment of redemptions involving related corporations	(7)	10	10	10	10	10	10	10	10	10	10	50	100
12. Conversion of large corporations into S corporations treated as complete liquidation	tyba 1/1/97	7	36	59	60	61	62	64	65	66	67	223	547
13. Reduction of 70% dividends received deduction ("DRD") to 50%	dr/a 30da DOE	242	298	312	328	344	362	380	399	419	440	1,524	3,524
14. Modification of holding period applicable to DRD[8]	dr/a 30 daDOE	6	9	11	12	12	13	13	14	15	15	50	120
15. Treat certain preferred stock as "boot."	Ta 12/7/95	227	150	154	160	104	33	34	36	38	40	795	976
16. Registration of certain confidential corporate tax shelters	aioIRSg	(9)	(9)	(9)	(9)	(9)	(9)	(9)	(9)	(9)	(9)	(10)	(11)

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET PROPOSAL RELEASED ON MARCH 19, 1996

Fiscal Years 1997–2006

[Millions of Dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1997–01	1997–06
17. Denial of deduction for interest on loans with respect to company-owned life insurance	ipoaa 9/18/95	1,472	1,508	1,674	1,795	1,852	1,880	1,917	1,939	1,956	1,973	8,300	17,966
18. Modify Puerto Rico and possessions tax credit (section 936)	tyba DOE	56	175	308	455	616	718	754	792	831	870	1,610	5,575
19. Further restrict like-kind exchanges involving foreign property	eoa 12/31/95	6	8	11	13	15	17	19	21	23	25	53	158
20. Modification of loss carry-back and carry-forward rules; restrict to 1-year carry-back	NOL tyba DOE	−27	1,297	1,651	1,107	704	515	439	400	380	360	4,732	6,826
21. Repeal percentage depletion for certain non-fuel minerals mined on Federal lands	tyba DOE	34	63	64	66	67	69	71	72	74	76	294	656
C. Foreign Provisions:													
1. Modification of rules relating to foreign trusts having one or more United States beneficiaries	various	85	171	180	188	197	206	214	223	245	258	821	1,967
2. Eliminate interest allocation exception for certain nonfinancial corporations	tyba DOE	43	101	123	141	163	187	201	215	228	241	571	1,643
3. Taxation of certain captive insurance companies and their shareholders	tyba DOE	46	65	−21	−27	−20	−18	−15	−12	−11	−10	43	−23

Provision	Effective												
4. Expand subpart F provisions regarding income from notional principal contracts and stock lending transactions	tyba DOE	9	20	20	21	21	21	21	22	22	22	90	198
5. Modification to foreign tax credit carryback and carryover periods	ftc tyba 12/31/96	75	500	450	425	400	375	265	265	263	259	1,850	3,277
6. Modification of foreign tax credit rules applicable to dual capacity taxpayers	tyba DOE	215	340	360	380	400	420	440	460	480	495	1,695	3,990
D. Accounting Provisions:													
1. Termination of suspense accounts for family farm corporations required to use accrual accounting, with inclusion in income of the adjustment for the change in accounting method over 10 years	tyba 9/13/95	121	72	73	74	75	76	77	78	78	30	415	754
2. Require thrifts to account for bad debts in the same manner as banks	tyba DOE 12/31/95	58	87	212	277	272	267	254	240	104	29	906	1,800
3. Reform depreciation under the income forecast method	ppisa 9/13/95	101	29	13	14	16	19	22	26	30	34	173	304
4. Repeal of lower-of-cost-or-market method of accounting for inventories	tyba DOE	275	310	316	312	136	66	47	52	56	60	1,349	1,630
5. Repeal of components-of-cost method of accounting for inventories	tyba DOE	103	131	148	157	169	179	191	203	214	220	708	1,715
E. Administrative Provisions:													
1. Repeal of diesel fuel tax rebate to purchasers of diesel-powered automobiles, vans, and light trucks	DOE	13	19	19	19	19	19	19	19	19	19	89	184
2. Increase penalties for failure to file correct information returns	rda 90 daDOE	2	7	15	23	24	25	27	28	29	31	71	211
3. Require tax reporting for payments to attorneys; delay effective date for 1 year	pma 12/31/96	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[10]	[11]

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET PROPOSAL RELEASED ON MARCH 19, 1996

Fiscal Years 1997–2006

[Millions of Dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1997–01	1997–06
4. Apply failure to pay penalty to substitute returns	DOE	1	3	30	32	33	35	37	38	40	42	99	291
5. Repeal exemption for withholding on gambling winnings from bingo and keno where proceeds exceed $5,000	DOE	21	6	6	6	7	7	7	7	8	8	46	83
6. Require reporting of payments to corporations rendering services to Federal agencies	rda 90 daDOE	5	7	7	8	9	10	11	11	12	12	36	92
7. Disclosure of returns concerning cash transactions ...	DOE	No Revenue Effect											
8. Reinstatement of authority for undercover operations ...	DOE	([12])	([12])	([12])	([12])	([12])	([12])	([12])	([12])	([12])	([12])	([9])	([13])
9. Information sharing provision: extension of disclosure of return information to Department of Veterans Affairs (outlay reduction) (extend through 9/30/02) [14]	DOE	—	—	14	28	42	56	—	—	—	—	84	140
10. Extend IRS user fees through 9/30/02 [14] [15]	10/1/00	—	—	—	—	—	—	—	—	—	—	—	—
F. Casualty and Involuntary Conversion Provisions:													
1. Modify basis adjustment rules under section 1033	icoa 9/13/95	6	7	11	16	23	31	40	49	60	68	63	311
2. Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person	ica 9/13/95	3	4	6	8	11	13	15	17	19	21	32	117

G. Excise Tax on Amounts of Private Excess Benefits	9/14/95 & tyba 12/31/95	7	4	4	5	5	5	6	6	6	7	25	55
H. Other Excise Taxes:													
1. Extend Superfund excise taxes through 9/30/06[16]	DOE	450	694	707	720	735	750	766	783	801	819	3,306	7,225
2. Extend Superfund AMT	tyba 12/31/95	963	633	647	672	700	729	760	792	825	859	3,615	7,580
3. Extend oil spill tax through 9/30/02 and increase the cap on the unobligated balances in the trust fund to $2.5 billion	DOE	154	237	241	245	250	254	259	55	57	—	1,127	1,752
4. Extend "LUST" excise taxes through 9/30/06	DOE	121	121	121	122	123	123	123	124	124	125	608	1,227
5. Extend luxury automobile excise tax permanently	DOE	—	—	21	325	431	455	471	482	509	526	777	3,220
6. Extension of Airport and Airway Trust Fund excise taxes through 9/30/06	DOE	3,916	4,840	5,130	5,427	5,741	6,074	6,427	6,801	7,197	7,616	25,054	59,169
7. Treat kerosene as diesel fuel for excise tax purposes	7/1/97	43	40	46	43	42	41	42	44	47	49	214	437
I. Employment Taxes:													
1. Extend the FUTA surcharge[14]	1/1/99	—	—	871	1,192	1,211	1,231	1,250	1,270	1,240	1,310	3,274	9,575
2. Require monthly deposits for FUTA taxes[14]	mba 12/31/01	—	—	—	—	—	1,362	42	37	50	52	—	1,543
J. Other Provisions Relating to Individuals:													
1. No rollover or exclusion of gain on sale of principal residence which is attributable to depreciation deductions	tyea 12/31/96	1	3	4	5	6	8	9	10	11	13	19	69
2. Personal exemption and dependent care credit disallowed without taxpayer identification number	rdal 30 daDOE	133	272	262	249	242	234	226	217	209	201	1,158	2,245
K. Earned Income Credit Provisions: compliance proposals; disqualified income changes; modified AGI for the purposes of the phaseout of the EIC; and provide advance payment of the credit through State demonstration programs	rdal 30 daDOE & tyba 12/31/95	505	517	525	545	561	593	621	646	672	699	2,653	5,884

APPENDIX:—Continued

ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET PROPOSAL RELEASED ON MARCH 19, 1996

Fiscal Years 1997-2006

[Millions of Dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1997-01	1997-06
Subtotal: Corporate Reform and Other Revenue Provisions		10,726	13,912	16,044	16,983	17,129	18,911	18,027	18,468	19,025	19,622	74,794	168,849
VI. Hazardous Duty Areas													
Extend certain tax benefits to Armed Forces personnel serving in the former Yugoslavia; raise the monthly exclusion from income for combat pay for officers from $500/month to the highest pay level for enlisted personnel; and conform wage withholding rule to income exclusion rule for officers [15]	11/21/95	—	—	—	—	—	—	—	—	—	—	—	—
Net Total		−7,663	−1,901	−2,520	−6,960	−1,696	15,750	14,261	14,182	14,211	14,528	−20,744	52,190

Note.—Details may not add to totals due to rounding. Estimates assume enactment date of October 1, 1996.

Legend for "Effective" column:

aiolRSg=after issuance of Internal Revenue Service guideline
asda=annuity starting date after
csa=constructive sales after
da=distributions after
dda=decedents dying after
dia=debt issued after
dio/a=debt instruments on or after
DOE=date of enactment
DOE+30 days=30 days after date of enactment
dr/a 30 daDOE=dividends received or accrued 30 days after the date of enactment
eaii GATT=effective as if included in GATT
eia=expenses incurred after
eoa=exchanges on or after
ftc tyba=foreign tax credits arising in taxable years beginning after
ipoaa=interest paid or accrued after
ica=involuntary conversion after
icoa=involuntary conversions occurring after
lyba=limitation years beginning after
mba=months beginning after
NOL tyba DOE=NOLs for taxable years beginning after date of enactment
pma=payments made after
ppisa=property placed in service after
ptoa=prohibited transactions occurring after
rda=reports due after
rda 90 daDOE=returns due after 90 days after date of enactment
rdal 30 daDOE=returns due at least 30 days after date of enactment
setomt 30 daDOE=sales, exchanges and terminations occurring more than 30 days after date of enactment
Ta=transactions after
ta=terminations after
tyba=taxable years beginning after
tyea=taxable years ending after
yba=years beginning after.

Footnotes for Appendix Table

[1] Estimate assumes that this provision reverts to present law after 12/31/00.

[2] Loss of less than $500,000.

[3] Possible outlay effect of proposals contained in pension simplification provisions which relate to ERISA are not included in this total. These proposals would be estimated by the Congressional Budget Office.

[4] New bond rules effective for qualified enterprise zone bonds issued after date of enactment; two new zones eligible for existing incentives designated within 180 days of enactment; and other new zones and communities designated after date of enactment and before 1/1/98.

[5] Effective for constructive sales occurring either (1) after date of enactment; or (2) after 1/12/96, and before the date of enactment if the position giving rise to the constructive sales remains outstanding 30 days after the date of enactment.

[6] Effective for taxable years beginning after date of enactment with respect to obligations acquired after 12/6/95.

[7] Effective distributions/acquisitions after 3/19/96, with transition rules.

[8] Includes interaction with 50% DRD provision.

[9] Gain of less than $5 million.

[10] Gain of less than $25 million.

[11] Gain of less than $30 million.

[12] Gain of less than $1 million.

[13] Gain of less than $10 million.

[14] Estimate provided by the Congressional Budget Office.

[15] Passed by the House and Senate in H.R. 2778, and signed into law by the President on March 20, 1996 (P.L. 104–117). Thus, there is no revenue effect shown in this table since the provision already has been enacted.

[16] This provision is estimated to be effective on the date of enactment, but consistent with instructions contained in the Congressional budget resolution.

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