

**DESCRIPTION OF CHAIRMAN'S MARK
RELATING TO
REVENUE RECONCILIATION PROVISIONS**

Scheduled for Markup

Before the

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Prepared by the Staff

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of revenue reconciliation provisions, beginning on June 11, 1997. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark for the revenue reconciliation provisions: (I) child and dependent care tax credits and health care for children of high-risk individuals; (II) education tax incentives; (III) savings and investment tax incentives; (IV) alternative minimum tax provisions; (V) estate, gift, and generation-skipping tax provisions; (VI) extension of certain expiring tax provisions; (VII) District of Columbia tax incentives; (VIII) welfare-to-work tax credit; (IX) revenue-increase provisions; (X) miscellaneous provisions; (XI) foreign tax provisions; (XII) earned income credit compliance; and (XIII) increase in the public debt limit.

Separate documents provide descriptions of tax simplification and technical corrections provisions of the Chairman's mark. Also, a separate document contains estimated budget effects of the revenue reconciliation, tax simplification, and technical corrections provisions.

¹ This document may be cited as follows: Joint Committee on Taxation, Description of Chairman's Mark Relating to Revenue Reconciliation Provisions (JCX-20-97), June 9, 1997.

I. CHILD AND DEPENDENT CARE TAX CREDITS; HEALTH CARE FOR CHILDREN

A. Child Tax Credit For Children Under Age 17

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 \$2,650 for 1997, and is adjusted annually for inflation. In 1997, the amount of the personal exemption is phased out for taxpayers with AGI in excess of \$121,200 for single taxpayers, \$151,500 for heads of household, and \$181,800 for married couples filing joint returns. These phaseout thresholds are adjusted annually for inflation.

Dependent care credit

A nonrefundable credit against income tax liability is available for up to 30 percent (phased down to 20 percent for individuals with AGI above \$28,000) of a limited dollar amount of employment-related child and dependent care expenses. Eligible employment-related expenses are limited to \$2,400 if there is one qualifying individual and \$4,800 if there are two or more qualifying individuals. Employment-related expenses are expenses for household services and the care of a qualifying individual, if incurred to enable the taxpayer to be gainfully employed. Employment-related expenses are reduced to the extent the taxpayer has employer-provided dependent care assistance that is excludable from gross income.

Description of Proposal

The proposal would allow taxpayers a maximum nonrefundable tax credit of \$500 (\$400 for taxable year 1998) for each qualifying child under the age of 17. A qualifying child would be defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. The credit amount would not be indexed for inflation.

For taxpayers with AGI in excess of certain thresholds, the sum of the otherwise allowable child credit and the otherwise allowable dependent care credit would be phased out. Specifically, the sum of the otherwise allowable child credit and then the otherwise allowable dependent care credit would be reduced by \$25 for each \$1,000 of AGI (or fraction thereof) in excess of the threshold ("the AGI phase-out"). The reduction would be applied first to the child

credit and then to the dependent care credit. For married taxpayers filing joint returns, the threshold would be \$110,000. For taxpayers filing single or head of household returns, the threshold would be \$75,000. For married taxpayers filing separate returns, the threshold would be \$55,000. These thresholds would not be indexed for inflation.

Beginning after 2001, after application of the AGI phase-out to both the child credit and the dependent care credit, the otherwise allowable child credit would be reduced by one-half of the amount of the taxpayer's dependent care credit. The maximum amount of the child credit for each taxable year (after the reduction, if any, for the dependent care credit after 2001) could not exceed an amount equal to the excess of: (1) the taxpayer's regular income tax liability (net of applicable credits) less (2) the sum of the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit) and the earned income credit allowed.

Effective Date

Generally, the child tax credit would be effective for taxable years beginning after December 31, 1997. The proposal to reduce the otherwise allowable child credit by one-half of the amount of the taxpayer's dependent care credit would be effective for taxable years beginning after December 31, 2001.

B. Indexing of the Dependent Care Credit; Phase Out for High-Income Taxpayers

Present Law

A nonrefundable credit against income tax liability is available for up to 30 percent of a limited dollar amount of employment-related child and dependent care expenses. The credit may be claimed by an individual who maintains a household that includes one or more qualifying individuals. A qualifying individual is a dependent of the taxpayer who is under the age of 13, a physically or mentally incapacitated dependent, or a physically or mentally incapacitated spouse. A married couple must file a joint return in order to claim the credit.

Employment-related expenses are expenses for household services and the care of a qualifying individual, if incurred to enable the taxpayer to be gainfully employed. The amount of employment-related expenses that may be taken into account in computing the credit generally may not exceed an individual's earned income or, in the case of married taxpayers, the earned income of the spouse with the lesser earnings. Thus, if one spouse is not employed, no credit is generally allowed. Eligible employment-related expenses are limited to \$2,400 if there is one qualifying individual, and \$4,800 if there are two or more qualifying individuals. The amount of employment-related expenses is reduced by the aggregate amount of employer-provided dependent care assistance excluded from the taxpayer's income.²

The 30-percent credit rate is reduced by one percentage point for each \$2,000 (or fraction thereof) of adjusted gross income ("AGI") above \$10,000. A married couple's combined AGI is used for purposes of this computation. Individuals with more than \$28,000 of AGI are entitled to a credit equal to 20 percent of allowable employment-related expenses.

Description of Proposal

The dollar limits on eligible employment-related expenses (\$2,400 if there is one qualifying individual and \$4,800 if there are two or more qualifying individuals) would be indexed for inflation.

The sum of the otherwise allowable dependent care credit and the otherwise allowable child credit would be phased out for taxpayers with AGI in excess of certain thresholds. Specifically, the sum of the otherwise allowable child credit and then the otherwise allowable dependent care credit would be reduced by \$25 for each \$1,000 of AGI (or fraction thereof) in excess of the threshold. The reduction would be applied first to the child credit and then to the

² Up to \$5,000 annually of employer-provided dependent care assistance is excludable from gross income if the assistance is provided under a separate written plan of the employer that does not discriminate in favor of highly compensated employees and certain other requirements are satisfied.

dependent care credit. For married taxpayers filing joint returns, the threshold would be \$110,000. For taxpayers filing single or head of household returns, the threshold would be \$75,000. These thresholds would not be indexed for inflation.

Effective Date

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

C. Expand Definition of High-Risk Individuals with Respect to Tax-Exempt State-Sponsored Organizations Providing Health Coverage

Present Law

Present law provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied.³ The organization may provide coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

Present law further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

Description of Proposal

The proposal would expand the definition of high-risk individuals to include a child of an individual who meets the present-law definition of a high-risk individual, subject to certain requirements. The requirements would be: (1) the taxpayer is allowed a deduction for a personal exemption for the child for the taxable year; (2) the child has not attained the age of 17 as of the close of the calendar year in which the taxable year of the taxpayer begins; and (3) the child is a son or daughter or the taxpayer (or a dependent of either), a stepson or stepdaughter of the taxpayer, or an eligible foster child of the taxpayer.

Effective Date

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

³ No inference is intended as to the tax treatment of other types of State-sponsored organizations.

II. EDUCATION TAX INCENTIVES

A. Tax Benefits Relating to Education Expenses

1. HOPE credit for higher education tuition expenses

Present Law

Deductibility of education expenses

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). However, 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 meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

Exclusion for employer-provided educational assistance

A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to \$5,250 annually paid by his or her employer for educational assistance (sec. 127). In order for the exclusion to apply certain requirements must be satisfied, including a requirement that not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners. This special rule for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997 (and does not apply to graduate level courses beginning after June 30, 1996).

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education expenses would be deductible under section 162.

Exclusion for interest earned on savings bonds

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 fees (but not room and board expenses) required 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 modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between \$49,450 and \$64,450 (\$74,200 and \$104,200 for joint returns). 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.

Qualified scholarships

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. Section 117(c) specifically provides that the exclusion for qualified scholarships does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship.

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)).

Student loan forgiveness

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working 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 this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

Qualified State prepaid tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts

distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.⁵

Description of Proposal

In general

Individual taxpayers would be allowed to claim a non-refundable HOPE credit against Federal income taxes up to \$1,500 per student per year for 50 percent of qualified tuition and related expenses (but not room and board expenses) paid for the first two years of the student's post-secondary education in a degree or certificate program. The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The HOPE credit would be available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education. Beginning in 1998, the maximum credit amount of \$1,500 would be indexed for inflation, rounded down to the closest multiple of \$50.

The HOPE credit amount that a taxpayer could otherwise claim would be phased out ratably for taxpayers with modified AGI between \$40,000 and \$50,000 (\$80,000 and \$100,000 for joint returns). Modified AGI would include amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2001, the income phase-out ranges would be indexed for inflation, rounded down to the closest multiple of \$5,000.

The HOPE credit would be available in the taxable year the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified tuition expenses paid with the proceeds of a loan generally would be eligible for the HOPE credit (rather than repayment of the loan itself).⁶

Dependent students

A taxpayer could claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is

⁵ Specifically, section 529(c)(3)(A) provides that any distribution under a qualified State tuition program shall be includible in the gross income of the distributee in the same manner as provided under present-law section 72 to the extent not excluded from gross income under any other provision of the Code.

⁶ The Treasury Department would have authority to issue regulations providing that the HOPE credit would be recaptured in cases where the student or taxpayer receives a refund of tuition and related expenses with respect to which a credit was claimed in a prior year.

claimed. If a student is claimed as a dependent by the parent or other taxpayer, the eligible student him- or herself would not be entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student would be treated as paid by the parent (or other taxpayer) for purposes of the proposal.

Election of HOPE credit or proposed deduction for qualified higher education expenses

For each taxable year, a taxpayer may elect with respect to an eligible student either the HOPE credit or the proposed deduction for qualified higher education expenses (described below). Thus, for example, if a parent claims a child as a dependent for a taxable year, then all qualified tuition expenses paid by both the parent and child would be deemed to be paid by the parent, and the parent may claim the HOPE credit (assuming that the AGI phaseout does not apply) on the parent's return. As an alternative, the parent could elect for that taxable year the proposed deduction for qualified higher education expenses with respect to the dependent child (as described below).⁷ On the other hand, if a child is not claimed as a dependent by the parent (or by any other taxpayer) for the taxable year, then the child him- or herself will have the option of electing either the HOPE credit or proposed deduction for qualified higher education expenses paid during that year.

Qualified tuition expenses

The HOPE credit would be available for "qualified tuition and related expenses," meaning tuition, fees, and books required for the enrollment or attendance of an eligible student at an eligible educational institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal, living or family expenses would not be included. The expenses of education involving sports, games, or hobbies would not be qualified tuition expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally would include only out-of-pocket expenses. Qualified tuition expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total tuition and related expenses would be reduced by scholarship or fellowship grants excludable from gross income under present-law section 117 and any other tax-free educational benefits. No reduction of qualified tuition expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). Under

⁷ For any taxable year, a taxpayer may claim the HOPE credit for qualified tuition and related expenses paid with respect to one student and also claim the proposed deduction (described below) for higher education expenses paid with respect to one or more other students. If the HOPE credit is claimed with respect to one student for one or two taxable years, then the proposed deduction for higher education expenses may be claimed with respect to that student for subsequent taxable years.

the proposal, a HOPE credit would not be allowed with respect to any education expenses for which a deduction is claimed under section 162 or any other section of the Code.⁸

Eligible student

An eligible student would be one who is enrolled 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 eligible educational institution. The student must pursue a course of study on at least a half-time basis. (In other words, for at least one academic period which begins during the taxable year, the student must carry at least one-half the normal full-time work load for the course of study the student is pursuing.) An eligible student could not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institution

Under the proposal, eligible educational institutions would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally would be accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also would be eligible educational institutions. The institution must be eligible to participate in Department of Education student aid programs.

Regulations

The Secretary of the Treasury (in consultation with the Secretary of Education) would have authority to issue regulations to implement the proposal, including regulations providing appropriate rules for recordkeeping and information reporting. These regulations would address the information reports that eligible educational institutions would be required to file to assist students and the IRS in calculating the amount of the HOPE credit potentially available. Where certain terms are defined by reference to the Higher Education Act of 1965, the Secretary of Education would have authority to issue regulations, as well as authority to define other education terms as necessary.

Effective Date

⁸ In addition, the proposal would amend present-law section 135 to provide that the amount of qualified higher education expenses taken into account for purposes of that section would be reduced by the amount of such expenses taken into account in determining the HOPE credit allowed to any taxpayer with respect to the student for the taxable year.

The proposal would be effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

2. Deduction for qualified higher education expenses and tax treatment of qualified tuition programs and education investment accounts

Present Law

Deductibility of education expenses

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). However, 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 meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

Exclusion for employer-provided educational assistance

A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to \$5,250 annually paid by his or her employer for educational assistance (sec. 127). In order for the exclusion to apply certain requirements must be satisfied, including a requirement that not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners. This special rule for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997 (and does not apply to graduate level courses beginning after June 30, 1996).

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education expenses would be deductible under section 162.

Exclusion for interest earned on savings bonds

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.⁹ "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required 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 modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between \$49,450 and \$64,450 (\$74,200 and \$104,200 for joint returns). 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.

Qualified scholarships

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. Section 117(c) specifically provides that the exclusion for qualified scholarships does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship.

⁹ 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)).

Student loan forgiveness

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working 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 this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

Qualified State prepaid tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the

contributor's gross income to the extent such amounts exceed contributions made by that person.¹⁰

Contributions made to a qualified State tuition program are treated as incomplete gifts for Federal gift tax purposes (sec. 529(c)(2)). Thus, any Federal gift tax consequences are determined at the time that a distribution is made from an account under the program. The waiver (or payment) of qualified higher education expenses of a designated beneficiary by (or to) an educational institution under a qualified State tuition program is treated as a qualified transfer for purposes of present-law section 2503(e). Amounts contributed to a qualified State tuition program (and earnings thereon) are includible in the contributor's estate for Federal estate tax purposes in the event that the contributor dies before such amounts are distributed under the program (sec. 529(c)(4)).

Individual retirement arrangements ("IRAs")

An individual may make deductible contributions to an individual retirement arrangement ("IRA") for each taxable year up to the lesser of \$2,000 or the amount of the individual's compensation for the year if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). Contributions may be made to an IRA for a taxable year up to April 15th of the following year. An individual who makes excess contributions to an IRA, i.e., contributions in excess of \$2,000, is subject to an excise tax on such excess contributions unless they are distributed from the IRA before the due date for filing the individual's tax return for the year (including extensions). If the individual (or his or her spouse, if married) is an active participant, the \$2,000 limit is phased out between \$40,000 and \$50,000 of adjusted gross income ("AGI") for married couples and between \$25,000 and \$35,000 of AGI for single individuals.

Present law permits individuals to make nondeductible contributions (up to \$2,000 per year) to an IRA to the extent an individual is not permitted to (or does not) make deductible contributions. Earnings on such contributions are includible in gross income when withdrawn.

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. Amounts withdrawn from an IRA are includible in gross income (except to the extent of nondeductible contributions). In addition, a 10-percent additional tax generally applies to distributions from IRAs made before age 59-1/2, unless the distribution is made (1) on account of death or disability, (2) in the form of annuity payments, (3) for medical expenses of the individual and his

¹⁰ Specifically, section 529(c)(3)(A) provides that any distribution under a qualified State tuition program shall be includible in the gross income of the distributee in the same manner as provided under present-law section 72 to the extent not excluded from gross income under any other provision of the Code.

or her spouse and dependents that exceed 7.5 percent of AGI, or (4) for medical insurance of the individual and his or her spouse and dependents (without regard to the 7.5 percent of AGI floor) if the individual has received unemployment compensation for at least 12 weeks, and the withdrawal is made in the year such unemployment compensation is received or the following year.

Description of Proposal

In general

Individual taxpayers would be allowed a deduction of up to \$10,000 per student per year for qualified higher education expenses paid by the taxpayer during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, or a dependent. The deduction would be allowed regardless of whether the taxpayer otherwise itemizes deductions or claims the standard deduction.¹¹ A deduction would not be allowed under the proposal with respect to an otherwise eligible student if the proposed HOPE credit (as described previously) is claimed with respect to that student for the same taxable year.¹²

The deduction would be allowed only to the extent that the taxpayer is required to include in gross income for the taxable year amounts distributed from a "qualified tuition program" or "education investment account." In other words, amounts distributed from a qualified tuition program or education investment account that are includible in the taxpayer's gross income (i.e., earnings) and that are used to pay for qualified higher education expenses during the taxable year would be deductible under the proposal (subject to the \$10,000 annual limit per student). Amounts distributed from qualified tuition programs or education investment accounts generally would be includible in the gross income of the distributee in the same manner as provided under present-law section 72 (to the extent not excluded under any other section, such as section 117).¹³

¹¹ The deduction would be claimed after a taxpayer computes adjusted gross income (AGI). The deduction would not be a preference item alternative minimum tax (AMT) purposes.

¹² If a HOPE credit was claimed with respect to a student for an earlier taxable year (i.e., the student's first or second year of post-secondary education), the proposed deduction still could be claimed with respect to that student for a subsequent taxable year.

¹³ For example, assume an educational investment account (or qualified tuition program account) has a balance of \$20,000, of which \$12,000 represents contributions of principal and \$8,000 represents accumulated earnings. If the student has expenses of \$10,000 consisting of \$7,000 tuition and related expenses and \$3,000 in room and board, a distribution of \$10,000 from such account to pay these expenses would, under present-law section 72, be deemed to consist of the pro-rata share of principal and accumulated earnings in the account--in this case, \$6,000 in principal and \$4,000 in accumulated earnings. If the parent claims the student as a dependent and elects the proposed deduction for qualified higher education expenses, the parent

Under the proposal, the deduction would be limited to \$10,000 per student for each taxable year. Aggregate deductions under the proposal with respect to any one student could not exceed \$40,000 for all taxable years. A deduction would not be permitted with respect to a student after that student completes the equivalent of the first four years of post-secondary education at an eligible educational institution.

Dependent students

If a parent (or other taxpayer) claims a student as a dependent for a taxable year, then only the parent (or other taxpayer)--and not the student--could claim the deduction for qualified higher education expenses for that taxable year. In such a case where the parent claims the proposed deduction for qualified higher education expenses, amounts includible in gross income by reason of a distribution from a qualified tuition program or education investment account would be includible in the parent's (or other taxpayer's) gross income for that taxable year.¹⁴ If a parent (or other taxpayer) claims a student as a dependent for a taxable year, then all qualified higher education expenses paid that year by both the parent (or other taxpayer) and the student would be deemed to be paid by the parent (or other taxpayer). If the student is not claimed as a dependent by another taxpayer, then only the student him- or herself could claim the proposed deduction (or, as an alternative, the proposed HOPE credit described above) on the student's own tax return for the taxable year.

would include the \$4,000 of accumulated earnings in the parent's gross income and then would claim an offsetting deduction for the same \$4,000, thus resulting in no tax liability for the \$4,000 in earnings. Under no circumstances would the principal portion of any distribution from the account be includible in gross income, nor would a deduction be allowed under the proposal for education expenses paid with such principal. Alternatively, the parent could elect to claim the HOPE credit (assuming that the AGI phaseout does not apply and the student is claimed as a dependent and has not yet completed the first two years of post-secondary education), and the \$4,000 in accumulated earnings would be includible in the distributee's (i.e., the student's) gross income and an offsetting deduction would not be available. Additionally, the qualified expenses for purposes of the HOPE credit would not include room and board expenses, so only \$7,000 in expenses would qualify for the HOPE credit. The 50-percent HOPE credit rate would then be applied to this amount, which would indicate a credit amount of \$3,500, but the credit that could be claimed would be limited to the statutory maximum of \$1,500 per student. As a final alternative, if the parent does not claim the student as a dependent, then the student could elect to claim either the HOPE credit or the proposed deduction as described above.

¹⁴ Such an income inclusion would be required on the parent's return only if the parent both claims the student as a dependent and elects the proposed deduction. In contrast, if the parent claims the student as a dependent but elects the HOPE credit, then, if there is any distribution from a qualified tuition program or education investment account during that year, the earnings portion of such distributions would be includible in the student's (or other distributee's) gross income, as provided for by present-law section 529(c)(3).

Eligible students

To be eligible for the proposed deduction, a student would have to be at least a half-time student in a degree or certificate program at an eligible educational institution. For this purpose, a student would be at least a half-time student if he or she is carrying at least one-half the normal full-time work load for the course of study the student is pursuing. A student would no longer be an eligible student once he or she has completed the equivalent of the first four years of post-secondary education at an eligible educational institution. An eligible student could not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institution

Under the proposal, eligible educational institutions would be defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally would be accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also would be eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Qualified higher education expenses

Under the proposal, the definition of "qualified higher education expenses" would include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible education institution, and also would include reasonable costs (as determined for purposes of Federal financial aid programs) incurred by the student for room and board while attending such institution. Qualified higher education expenses would not include expenses for any graduate level course of a kind normally taken by an individual pursuing a program leading to a law, business, medical, or other advanced academic or professional degree.

Qualified higher education expenses generally would include only out-of-pocket expenses. Qualified higher education expenses would not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified higher education expenses would be reduced by scholarship or fellowship grants excludable from gross income under present-law section 117 and any other tax-free educational benefits. In addition, no deduction would be allowed under the proposal for expenses paid with amounts that are excludable under section 135. No reduction of qualified tuition expenses would be required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). If a student's education expenses for a taxable year are deducted under section 162 or any other section of the Code, then no deduction would be available for such expenses under the proposal.

Qualified tuition programs and education investments accounts

Under the proposal, a "qualified tuition program" would mean any qualified State tuition program, generally as defined under present-law section 529, as well as any program established and maintained by one or more eligible educational institutions (which could be private institutions that are not State-owned) that satisfy the requirements under section 529 (other than present-law State ownership rule). An "education investment account" would mean a trust which is created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the account holder and which satisfies certain other requirements.

Contributions to qualified tuition programs or education investment accounts could be made only in cash.¹⁵ Such contributions could not be made after the designated beneficiary or account holder reaches age 18. Any balance remaining in a qualified tuition program or education investment account must be distributed within 30 days after the earlier of the date that the beneficiary or account holder becomes 30 years old (or dies) or the date that the beneficiary or account holder completes the equivalent of the first four years of post-secondary education at one or more eligible institutions. Transfers or rollovers of credits or account balances from one account benefiting one beneficiary to another account benefiting another beneficiary would not be considered a distribution from a qualified tuition program or education investment account (nor would a change in the designated beneficiary or account holder) if the new beneficiary is a member of the family of the old beneficiary.¹⁶ In the case of an education investment account, additional contributions could not be made into such an account on behalf of the account holder after aggregate contributions made to the account (plus all other contributions made to

¹⁵ The proposal would allow taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under section 135 (as if the proceeds were used to pay qualified higher education expenses) if the proceeds from the redemption are contributed to a qualified tuition program or education investment account on behalf of the taxpayer, the taxpayer's spouse, or a dependent. In such a case, the beneficiary's or account holder's basis in the bond proceeds contributed on his or her behalf to the qualified tuition program or education investment would be the contributor's basis in the bonds (i.e., the original purchase price paid by the contributor for such bonds).

The proposal also would provide that funds from an education investment account would be deemed to be distributed to pay qualified higher education expenses if the funds are used to purchase tuition credits or to make contributions to a qualified tuition program for the benefit of the account holder.

¹⁶ For this purpose, a "member of the family" means persons described in paragraphs (1) through (8) of section 152(a), and any spouse of such persons.

educational investment accounts and qualified tuition programs on behalf of the account holder) equal \$50,000.¹⁷

Qualified tuition programs and education investment accounts (as separate legal entities) would be exempt from Federal income tax, other than taxes imposed under the present-law unrelated business income tax (UBIT) rules.¹⁸

Under the proposal, an additional tax of 10 percent would be imposed on distributions from qualified tuition programs or education investment account to the extent the distribution exceeds qualified higher education expenses paid by the taxpayer (and is not made on account of the death, disability, or scholarship received by the designated beneficiary or account holder).

Estate and gift tax treatment

For Federal estate and gift tax purposes, any contribution to a qualified tuition program or education investment account would be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Thus, annual contributions of up to \$10,000 per donor per beneficiary would be eligible for the present-law gift tax exclusion provided by Code section 2503(b), and also would be excludable for purposes of the generation-skipping transfer tax. Such contributions would not, however, be eligible for the educational expense exclusion provided by Code section 2503(e). In no event would a distribution from a qualified tuition program or education investment account be treated as a taxable gift.

Transfers or rollovers of credits or account balances from an account benefiting one beneficiary to an account benefiting another beneficiary (or a change in the designated beneficiary) would not be treated as a taxable gift to the extent that the new beneficiary is: (1) a member of the family of the old beneficiary (as defined above), and (2) assigned to the same generation as the old beneficiary (within the meaning of Code section 2651). In all other cases, a transfer from one beneficiary to another beneficiary (or a change in the designated beneficiary) would be treated as a taxable gift from the old beneficiary to the new beneficiary to the extent it exceeds the \$10,000 present-law gift tax exclusion. Thus, a transfer of an account from a brother to his sister would not be treated as a taxable gift, whereas a transfer from a father to his son would be treated as a taxable gift (to the extent it exceeds the \$10,000 present-law gift tax exclusion).

¹⁷ Qualified tuition programs would be governed by the rule contained in present-law section 529(b)(7) that such programs provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary.

¹⁸ An interest in a qualified tuition program will not be treated as debt for purposes of the debt-financed property UBIT rules of section 514.

For estate tax purposes, the value of any interest in a qualified tuition program or education investment account would be includible in the estate of the designated beneficiary. In no event would such interests be includible in the estate of the contributor.

Effective Date

The proposed deduction for qualified higher education expenses (and the expansion of the definition of qualified higher education expenses under sec. 529 to cover room and board expenses) would be effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date. The provisions governing the tax-exempt status of qualified tuition plans and education investment accounts generally would be effective for taxable years beginning after December 31, 1997. The gift tax provisions would be effective for contributions (or transfers) made after the date of enactment, and the estate tax provisions would be effective for decedents dying after June 8, 1997.

3. Penalty-free withdrawals from IRAs for higher education expenses

Present Law

An individual may make deductible contributions to an individual retirement arrangement ("IRA") for each taxable year up to the lesser of \$2,000 or the amount of the individual's compensation for the year if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). In the case of a married couple, deductible IRA contributions of up to \$2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 deduction limit is phased out over certain adjusted gross income ("AGI") levels. The limit is phased out between \$40,000 and \$50,000 of AGI for married taxpayers, and between \$25,000 and \$35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70-1/2.

Amounts held in an IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

Description of Proposal

The proposal would provide that the 10-percent early withdrawal tax would not apply to distributions from IRAs¹⁹ if the taxpayer used the amounts to pay qualified higher education expenses (including those related to graduate level courses) of the taxpayer, the taxpayer's spouse, or any child, or grandchild of the individual or the individual's spouse.

The penalty-free withdrawal would be available for "qualified higher education expenses," meaning tuition, fees, books, supplies, equipment required for enrollment or attendance, and room and board at a post-secondary educational institution (defined by reference to sec 481 of the Higher Education Act of 1965). Qualified higher education expenses would be reduced by any amount excludable from gross income under section 135 relating to the redemption of a qualified U.S. savings bond and certain scholarships and veterans benefits.

Effective Date

The proposal would apply to distributions after December 31, 1997, which respect to expenses paid after such date for education furnished in academic periods beginning after such date.

¹⁹ The Chairman's mark would create new "American Dream IRAs" (see III.A., below). This exception to the 10-percent early withdrawal tax would apply to all IRAs, including the new American Dream IRAs.

B. Other Education-Related Tax Provisions

1. Extension of exclusion for employer-provided educational assistance

Present Law

Under present law, an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion is limited to \$5,250 of educational assistance with respect to an individual during a calendar year. The exclusion does not apply to graduate level courses beginning after June 30, 1996. The exclusion expires with respect to courses beginning after June 30, 1997. In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

Description of Proposal

The proposal would extend the exclusion for employer-provided educational assistance to courses of instruction beginning before December 31, 1997. As under present law, the exclusion would not apply to graduate-level courses.

Effective Date

The proposal would be effective with respect to taxable years beginning after December 31, 1996.

2. Modification of \$150 million limit on qualified 501(c)(3) bonds other than hospital bonds

Present Law

Interest on State and local government bonds generally is excluded from income if the bonds are issued to finance activities carried out and paid for with revenues of these governments. Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in Code section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business.

Present law treats section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(c)(3) bonds," subject to the restrictions of Code section 145. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to \$150 million. In applying this "\$150 million limit," all section 501(c)(3) organizations under common management or control

are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

Description of Proposal

The \$150 million limit would be increased annually in \$10 million increments until it is \$200 million. Specifically, the limitation would be \$160 million in 1998, \$170 million in 1999, \$180 million in 2000, \$190 million in 2001, and \$200 million in 2002 and thereafter.

Effective Date

The proposal would be effective on January 1, 1998.

3. Enhanced deduction for corporate contributions of computer technology and equipment

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.²⁰ However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose (sec. 170(e)(1)(B)(i)).

Special rules in the Code provide augmented deductions for certain corporate²¹ contributions of inventory property for the care of the ill, the needy, or infants (sec. 170(e)(3)) and certain corporate contributions of scientific equipment constructed by the taxpayer, provided the original use of such donated equipment is by the donee for research or research training in the United States in physical or biological sciences (sec. 170(e)(4)).²² Under these special rules,

²⁰ The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). Corporations are entitled to claim a deduction for charitable contributions, generally limited to 10 percent of their taxable income (computed without regard to the contributions) for the taxable year.

²¹ S corporations are not eligible donors for purposes of section 170(e)(3) or section 170(e)(4).

²² Eligible donees under section 170(e)(4) are limited to post-secondary educational institutions, scientific research organizations, and certain other organizations that support

the amount of the augmented deduction available to a corporation making a qualified contribution is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property.

Description of Proposal

The proposal would expand the list of qualified contributions that would qualify for the augmented deduction currently available under Code section 170(e)(3) and 170(e)(4). Under the proposal, qualified contributions would include gifts of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in any of grades K-12.

Eligible donees would mean (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) Code section 501(c)(3) entities that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also could be an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee.

Qualified contributions would be limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor. The proposal would permit payment by the donee organization of shipping, transfer, and installation costs.²³ The proposal would apply only to donations made by C corporations; as under present law section 170(e)(4), S corporations, personal holding companies, and service organizations would not be eligible donors.

Effective Date

The proposal would be effective for contributions made in taxable years beginning after 1997.

scientific research.

²³ In the case of contributions made through private foundations, the proposal would permit the payment by the private foundation of shipping, transfer, and installation costs.

4. Phase out qualified tuition reduction exclusion

Present Law

Under present law, a "qualified tuition reduction" is excluded from gross income (sec. 117(d)). A "qualified tuition reduction" means any reduction in tuition provided to an employee of an educational organization for the education of the employee,²⁴ the employee's spouse, and dependent children at that organization or another such organization. For this purpose, qualifying educational organizations are those that normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of pupils or students in attendance at the place where the educational activities are regularly carried out. In general, the qualified tuition reduction is limited to education below the graduate level; however, this limitation does not apply to graduate students engaged in teaching or research activities. The exclusion does not apply to any amount that represents payment for teaching, research, or other services rendered by the student in exchange for receiving the tuition reduction.

Description of Proposal

The proposal would phase out the special rule contained in section 117(d) that excludes qualified tuition reductions from gross income. For 1998, 80 percent of a qualified tuition reduction would be excluded from gross income. For 1999, the excludable percentage would be 60 percent; for 2000, the excludable percentage would be 40 percent; and for 2001, the excludable percentage would be 20 percent. No exclusion for a qualified tuition reduction would be permitted after 2001.

Educational benefits provided that are not excludable under the proposal could be eligible for the proposed HOPE credit or proposed deduction for qualified higher education expenses, described above.

Effective Date

The proposal would be effective for qualified tuition reductions with respect to courses of instruction beginning after December 31, 1997 (subject to the phaseout described above).

²⁴ Eligible beneficiaries also include retired and disabled employees, surviving spouses of retired or disabled employees, and children of deceased employees if the children are under the age of 25.

III. SAVINGS AND INVESTMENT TAX INCENTIVES

A. American Dream IRAs

Present Law

Under present law, an individual may make deductible contributions to an individual retirement arrangement ("IRA") up to the lesser of \$2,000 or the individual's compensation if the individual is not an active participant in an employer-sponsored retirement plan (and, if married, the individual's spouse also is not an active participant in such a plan). In the case of a married couple, deductible IRA contributions of up to \$2,000 can be made for each spouse (including, for example, a home maker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 deduction limit is phased out over certain adjusted gross income ("AGI") levels. The limit is phased out between \$40,000 and \$50,000 of AGI for married taxpayers, and between \$25,000 and \$35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70-1/2.

Amounts held in an IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

In general, distributions from an IRA are required to begin at age 70-1/2. An excise tax is imposed if the minimum required distributions are not made. Distributions to the beneficiary of an IRA are generally required to begin within 5 years of the death of the IRA owner, unless the beneficiary is the surviving spouse.

A 15-percent excise tax is imposed on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs. In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent such amounts exceed \$160,000 (for 1997) or 5 times that amount in the case of a lump-sum distribution. The dollar limit is indexed for inflation. A similar 15-percent additional estate tax applies to excess retirement accumulations upon the death of the individual. The 15-percent tax on excess distributions (but not the 15-percent additional estate tax) does not apply to distributions in 1997, 1998 or 1999.

Description of Proposal

In general

The proposal would replace present-law nondeductible IRAs with new American Dream IRAs ("AD IRAs") to which all individuals could make nondeductible contributions of up to \$2,000 annually. Contributions to an AD IRA would be in addition to any contributions that can be made to a deductible IRA under the present-law rules. No income limitations would apply to AD IRAs. An AD IRA would be an IRA which is designated at the time of establishment as an AD IRA in the manner prescribed by the Secretary. Qualified distributions from an AD IRA would not be includible in income.

Contributions to AD IRAs

The maximum annual contribution that could be made to an AD IRA would be the lesser of \$2,000 or the individual's compensation for the year. As under the present-law rules relating to deductible IRAs, a contribution of up to \$2,000 for each spouse could be made to an AD IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The \$2,000 contribution limit would be adjusted annually for inflation beginning after 1998. Inflation adjustments would be rounded to the nearest \$50.

Contributions to an AD IRA could be made even after the individual for whom the account is maintained has attained age 70-1/2.

Taxation of distributions

Qualified distributions from an AD IRA would not be includible in gross income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution would be a distribution that (1) is made after the 5-taxable year period beginning with the first taxable year in which the individual made a contribution to an AD IRA²⁵, and (2) which is (a) made on or after the date on which the individual attains age 59-1/2, (b) made to a beneficiary (or to the individual's estate) on or after the death of the individual, (c) attributable to the individual's being disabled, or (d) for first-time homebuyer expenses.

Distributions from an AD IRA that are not qualified distributions would be includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax

²⁵ As is the case with IRAs generally, contributions to an AD IRA could be made for a year by the due date for the individual's tax return for the year (determined without regard to extensions). In the case of a contribution to an AD IRA made after the end of the taxable year, the 5-year holding period would run beginning with the taxable year to which the contribution relates, rather than the year in which the contribution is actually made.

(unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs would apply to AD IRAs. Thus, the following distributions from an AD IRA would not be subject to the 10-percent early withdrawal tax: (1) distributions after age 59-1/2; (2) distributions after death or disability of the AD IRA owner; (3) certain periodic distributions; (4) distributions for medical expenses in excess of 7.5 percent of adjusted gross income; (5) distributions for medical insurance of unemployed individuals; and (6) distributions for higher education expenses.²⁶ In addition, the 10-percent early withdrawal tax would not apply to amounts withdrawn from an AD IRA used to pay first-time homebuyer expenses.²⁷

An ordering rule would apply for purposes of determining what portion of a distribution that is not a qualified distribution is includible in income. Under the ordering rule, distributions from an AD IRA would be treated as made from contributions first, and all an individual's AD IRAs would be treated as a single AD IRA. Thus, no portion of a distribution from an AD IRA would be treated as attributable to earnings (and therefore includible in gross income) until the total of all distributions from all the individual's AD IRAs exceeds the amount of contributions.

The pre-death minimum distribution rules that apply to IRAs would not apply to AD IRAs, and amounts in AD IRAs would not be taken into account for purposes of the excise tax on excess distributions or the additional estate tax on excess accumulations.

Distributions from an AD IRA could be rolled over tax free to another AD IRA.

Conversions of IRAs to AD IRAs

All or any part of amounts in a present-law deductible or nondeductible IRA could be converted into an AD IRA after December 31, 1997, and before January 1, 1999. The amount that would have been includible in gross income if the individual had withdrawn the converted amounts would be included in gross income ratably over the 4-taxable year period beginning with the taxable year in which the conversion is made. The early withdrawal tax would not apply to such conversions.²⁸

A conversion of an IRA into an AD IRA could be made in a variety of different ways and without taking a distribution. For example, an individual could make a conversion simply by notifying the IRA trustee. Or, an individual could make the conversion in connection with a

²⁶ This exception to the early withdrawal tax would be added by the Chairman's mark.

²⁷ This exception to the early withdrawal tax would not apply to IRAs other than AD IRAs.

²⁸ In the case of conversions from an IRA to an AD IRA, the 5-taxable year holding period would begin with the taxable year in which the conversion was made.

change in IRA trustees through a rollover or a trustee-to-trustee transfer. If a part of an IRA balance is converted into an AD IRA, the AD IRA amounts would have to be held separately.

Effective Date

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

B. Capital Gains Provisions

1. Maximum rate of tax on net capital gain of individuals

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain is taxed at the same rate as ordinary income, except that individuals are subject to a maximum marginal rate of 28 percent of the net capital gain. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

Description of Proposal

The proposal generally would reduce the maximum rate of tax on the net capital gain of an individual from 28 percent to 20 percent. Net capital gain presently taxed to an individual at a 15-percent rate would be taxed at a 10 percent rate. These rates also would apply for purposes of the alternative minimum tax.

The tax on the net capital gain attributable to any long-term capital gain from the sale or exchange of collectibles would remain at a maximum rate of 28 percent; any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real property) which would be treated as ordinary income if the property were section 1245 property (i.e. depreciable personal property) would be taxed at a maximum rate of 26 percent; and the tax treatment of gain from the sale or exchange of small business stock held more than 5 years would remain unchanged from present law (i.e., a maximum regular tax rate of 14 percent). Gain from the disposition of a collectible which is an indexed asset (described below) would not be eligible for the 28-percent rate unless the taxpayer elects to forego indexing.

Effective Date

The provision would apply to taxable years ending after May 6, 1997. For a taxable year which includes May 7, 1997, only the net capital gain attributable to gain or loss properly taken into account for the portion of the taxable year on or after May 7, 1997, would be entitled to the lower tax rates.

2. Indexing of basis of certain assets for purposes of determining gain

Present Law

Under present law, gain or loss from the disposition of any asset generally is the sales price of the asset reduced by the taxpayer's adjusted basis in that asset. The taxpayer's adjusted basis generally is the taxpayer's cost in the asset adjusted for depreciation, depletion, and certain other amounts. No adjustment is allowed for inflation.

Description of Proposal

In general

The proposal generally would provide for an inflation adjustment to (i.e., indexing of) the adjusted basis of certain assets (called "indexed assets") held more than 3 years for purposes of determining gain (but not loss) upon a sale or other disposition of such assets by a taxpayer other than a C corporation. Assets held by trusts, estates, S corporations, regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and partnerships are eligible for indexing, to the extent gain on such assets is taken into account by taxpayers other than C corporations.

Indexed assets

Assets eligible for the inflation adjustment generally would include common (but not preferred) stock of C corporations and tangible property that are capital assets or property used in a trade or business. A personal residence would not qualify for indexing. To be eligible for indexing, an asset must be held by the taxpayer for more than 3 years.

Computation of inflation adjustment

The inflation adjustment under the provision would be computed by multiplying the taxpayer's adjusted basis in the indexed asset by an inflation adjustment percentage. The inflation adjustment percentage would be the percentage by which the GDP deflator for the last calendar quarter ending before the disposition exceeds the GDP deflator for the last calendar quarter ending before the asset was acquired by the taxpayer. The inflation adjustment percentage would be rounded to the nearest one-tenth of a percent. No adjustment would be made if the inflation adjustment is one or less.

Special entities

RICs and REITs

In the case of a RIC or a REIT, the indexing adjustments generally would apply in computing the taxable income and the earnings and profits of the RIC or REIT. The indexing adjustments, however, would not be applicable in determining whether a corporation qualifies as a RIC or REIT.

In the case of shares held in a RIC or REIT, partial indexing generally would be provided by the provision based on the ratio of the value of indexed assets held by the entity to the value of all its assets. The ratio of indexed assets to total assets would be determined quarterly (for RICs, the quarterly ratio would be based on a three-month average). If the ratio of indexed assets to total assets exceeds 80 percent in any quarter, full indexing of the shares would be allowed for that quarter. If less than 20 percent of the assets are indexed assets in any quarter, no indexing would be allowed for that quarter for the shares. Partnership interests held by a RIC or REIT would be subject to a look-through test for purposes of determining whether, and to what degree, the shares in the RIC or REIT are indexed.

A return of capital distribution by a RIC or REIT generally would be treated by a shareholder as allocable to stock acquired by the shareholder in the order in which the stock was acquired.

Partnership and S corporations, etc.

Under the proposal, stock in an S corporation or an interest in a partnership or common trust fund would not be an indexed asset. Under the provision, the individual owner would receive the benefit of the indexing adjustment when the S corporation, partnership, or common trust fund disposes of indexed assets. Under the provision, any inflation adjustments at the entity level would flow through to the holders and result in a corresponding increase in the basis of the holder's interest in the entity. Where a partnership has a section 754 election in effect, a partner transferring his interest in the partnership would be entitled to any indexing adjustment that has accrued at the partnership level with respect to the partner and the transferee partner is entitled to the benefits of indexing for inflation occurring after the transfer.

The indexing adjustment would be disregarded in determining any loss on the sale of an interest in a partnership, S corporation or common trust fund.

Foreign corporations

Common stock of a foreign corporation generally would be an indexed asset if the stock is regularly traded on an established securities market. Indexed assets, however, would not include stock in a foreign investment company, a passive foreign investment company (including a qualified electing fund), a foreign personal holding company, or, in the hands of a shareholder

who meets the requirements of section 1248(a)(2) (generally pertaining to 10-percent shareholders of controlled foreign corporations), any other foreign corporation. An American Depository Receipt (ADR) for common stock in a foreign corporation would be treated as common stock in the foreign corporation and, therefore, the basis in an ADR for common stock generally would be indexed.

Other rules

Improvements and contributions to capital

No indexing would be provided for improvements or contributions to capital if the aggregate amount of the improvements or contributions to capital during the taxable year with respect to the property or stock is less than \$1,000. If the aggregate amount of such improvements or contributions to capital is \$1,000 or more, each addition would be treated as a separate asset acquired at the close of the taxable year.

Suspension of holding period

No indexing adjustment would be allowed during any period during which there is a substantial diminution of the taxpayer's risk of loss from holding the indexed asset by reason of any transaction entered into by the taxpayer, or a related party.

Short sales

In the case of a short sale of an indexed asset with a short sale period in excess of three years, the proposal would require that the amount realized be indexed for inflation for the short sale period.

Related parties

The proposal would not index the basis of property for sales or dispositions between related persons, except to the extent the adjusted basis of property in the hands of the transferee is a substituted basis (e.g., gifts).

Collapsible corporations

Under the proposal, indexing would not reduce the amount of ordinary gain that would be recognized in cases where a corporation is treated as a collapsible corporation (under Code sec. 341) with respect to a distribution or sale of stock.

Effective Date

The provision would apply to dispositions of property the holding period of which begins after December 31, 2000. An individual holding any indexed asset on January 1, 2000, may

elect to treat the indexed asset as having been sold and reacquired for its fair market value. Any gain would be deemed recognized on that date, and any loss would be disallowed (and not added to the basis of the indexed asset).

3. 30-percent corporate alternative tax for capital gains

Present Law

Under present law, the net capital gain of a corporation is taxed at the same rate as ordinary income, and subject to tax at graduated rates up to 35 percent.

Description of Proposal

The proposal would provide an alternative tax on the net capital gain of a corporation to the extent the gain is attributable to the sale or exchange of property held more than five years. The alternative tax would be 32 percent on the net capital gain attributable to calendar year 1998; 31 percent on the net capital gain attributable to calendar year 1999; and 30 percent on the net capital gain attributable to calendar years after 1999. The lower rates would not apply to gain from the sale of collectibles or to gain attributable to depreciation allowances.

Effective Date

The proposal would apply to taxable years ending after December 31, 1997.

4. Exclusion of gain on sale of principal residence

Present Law

Rollover of gain

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

One-time exclusion

In general, an individual, on a one-time basis, 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 owned the property and used it as a principal residence for three or more of the five years preceding the sale (sec. 121).

Description of Proposal

A taxpayer generally would be able to exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion would be allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years. The proposal provides that gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after May 6, 1997.

To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or other unforeseen circumstances would be able to exclude the fraction of the \$250,000 (\$500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

In the case of joint filers not sharing a principal residence, an exclusion of \$250,000 would be available on a qualifying sale or exchange of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the proposal would allow the newly married taxpayer a maximum exclusion of \$250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude \$500,000 of gain on their joint return.

Under the proposal, the gain from the sale or exchange of the remainder interest in the taxpayer's principal residence may qualify for the otherwise allowable exclusion.

Effective Date

The proposal would be available for all sales or exchanges of a principal residence occurring on or after May 7, 1997, and would replace the present-law rollover and one-time exclusion provisions applicable to principal residences.

A taxpayer could elect to apply present law (rather than the new exclusion) to a sale or exchange (1) made before the date of enactment of the Act, (2) made after the date of enactment pursuant to a binding contract in effect on the date or (3) where the replacement residence was acquired on or before the date of enactment (or pursuant to a binding contract in effect of the date of enactment) and the rollover provision would apply. If a taxpayer acquired his or her current residence in a rollover transaction, periods of ownership and use of the prior residence would be taken into account in determining ownership and use of the current residence.

IV. ALTERNATIVE MINIMUM TAX PROVISIONS

A. Increase Exemption Amount Applicable to Individual Alternative Minimum Tax

Present Law

Present law imposes a minimum tax on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. This alternative minimum tax is imposed upon individuals at rates of (1) 26 percent on the first \$175,000 of alternative minimum taxable income in excess of a phased-out exemption amount and (2) 28 percent on the amount in excess of \$175,000. The exemption amounts are \$45,000 in the case of married individuals filing a joint return and surviving spouses; \$33,750 in the case of other unmarried individuals; and \$22,500 in the case of married individuals filing a separate return. These exemption amounts are phased-out by an amount equal to 25 percent of the amount that the individual's alternative minimum taxable income exceeds a threshold amount. These threshold amounts are \$150,000 in the case of married individuals filing a joint return and surviving spouses; \$112,500 in the case of other unmarried individuals; and \$75,000 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts, the threshold phase-out amounts, and the \$175,000 break-point amount are not indexed for inflation.

Description of Proposal

For taxable years beginning in 1999, 2001, 2003, 2005 and 2007, the exemption amounts of the individual Alternative minimum tax would be increased as follows: (1) by \$1,000 in the case of married individuals filing a joint return and surviving spouses; (2) by \$750 in the case of other unmarried individuals; and (3) by \$500 in the case of married individuals filing a separate return. For taxable years beginning after 2007, the exemption amounts would be indexed for inflation.

Effective Date

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

B. Modify and Repeal Alternative Minimum Tax Applicable to Business Activities

Present Law

In general

Present law imposes a minimum tax on an individual or a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The individual minimum tax is imposed at rates of 26 and 28 percent on alternative minimum taxable income in excess of a phased-out exemption amount; the corporate minimum tax is imposed at a rate of 20 percent on alternative minimum taxable income in excess of a phased-out \$40,000 exemption amount. Alternative minimum taxable income ("AMTI") is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In the case of a corporation, in addition to the regular set of adjustments and preferences, there is a second set of adjustments known as the "adjusted current earnings" adjustment.

Preference items in computing AMTI

The minimum tax preference items are:

- (1) The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. For taxable years beginning after 1992, this preference does not apply to percentage depletion allowed with respect to oil and gas properties.
- (2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. For taxable years beginning after 1992, this preference does not apply to independent producers to the extent the producer's AMTI is reduced by 40 percent or less by ignoring the preference.
- (3) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.
- (4) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.
- (5) One-half of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock.)

In addition, losses from any tax shelter farm or passive activities are denied.²⁹

Adjustments in computing AMTI

The adjustments that all taxpayers must make are:

(1) Depreciation on property placed in service after 1986 must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (1) the straight-line method in the case of property subject to the straight-line method under the regular tax or (2) the 150-percent declining balance method in the case of other property.

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

(4) The amortization deduction allowed for pollution control facilities (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax) must be calculated under the alternative depreciation system.

(5) Dealers in property (other than certain dealers of timeshares and residential lots) may not use the instalment method of accounting.

The adjustments applicable to individuals are:

(1) Miscellaneous itemized deductions;

(2) State, local, and foreign real property taxes; state and local personal property taxes; and state, local, and foreign income, war profits, and excess profits taxes;

(3) Medical expenses except to the extent in excess of ten percent of the taxpayer's adjusted gross income;

(4) Standard deductions and personal exemptions;

(5) The amount allowable as a deduction for circulation expenditures must be capitalized and amortized over a 3-year period;

²⁹ Given the passage of section 469 (relating to the deductibility of losses from passive activities) these provisions are largely deadwood.

(6) The amount allowable as a deduction for research and experimental expenditures must be capitalized and amortized over a 10-year period³⁰; and

(7) The special rules relating to incentive stock options.

The adjustments applicable to corporations are:

(1) The special rules applicable to Merchant Marine capital construction funds;

(2) The special deduction allowable under section 833(b) (relating to Blue Cross and Blue Shield organizations); and

(3) The adjusted current earnings adjustment.

Adjusted current earnings (ACE) adjustment

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings (ACE) of a corporation exceeds its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction).³¹ In determining ACE, the following rules apply:

(1) For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.³²

(2) Any amount that is excluded from gross income under the regular tax but is included for purposes of determining earnings and profits is included in determining ACE.³³

(3) The inside build-up of a life insurance contract is includible in ACE (and the related premiums are deductible).

³⁰ No adjustment is required if the taxpayer materially participates in the activity that relates to the research and experimental expenditures.

³¹ If ACE is less than AMTI, the ACE adjustment may reduce AMTI to the extent of prior-year ACE inclusions.

³² No ACE adjustment is required for property placed in service after 1993.

³³ Exceptions and special rules are provided for related expenses that are not deductible for regular tax purposes but reduce earnings and profits, the dividends received deduction relating to certain dividends, taxes on dividends from 936 companies, and certain dividends received by certain cooperatives.

(4) Intangible drilling costs (other than those incurred by an independent producer after 1992) must be capitalized and amortized over a 60-month period.

(5) The regular tax rules of sections 173 (relating to circulation expenditure) and 248 (relating to organizational expenditures) do not apply.

(6) Inventory must be calculated using the FIFO, rather LIFO, method.

(7) The installment sales method generally may not be used.

(8) No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.

(9) Depletion (other than depletion claimed by an independent producer after 1992) must be calculated using the cost, rather than the percentage, method; and

(10) In certain cases, the assets of a corporation that has undergone an ownership change must be stepped-down to their fair market values.

Other rules

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's alternative minimum tax liability by more than 90 percent of the amount determined without these items.

The various credits allowed under the regular tax generally are not allowed against the alternative minimum tax.

If a taxpayer is subject to alternative minimum tax in one year, such amount of tax is allowed as a credit in a subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in such subsequent year. If the taxpayer is an individual, this credit is allowed to the extent the taxpayer's alternative minimum tax liability is a result of adjustments that are timing in nature.

Description of Proposal

Repeal of the corporate alternative minimum tax

In the case of a small business corporation, the alternative minimum tax would be repealed for taxable years beginning after December 31, 1997. A corporation that had average gross receipts of less than \$5 million for the three-year period beginning after December 31, 1994 would be a small business corporation for any taxable year beginning after December 31, 1997.

In the case of any other corporation, the alternative minimum tax would be repealed for taxable years beginning after December 31, 2006.

In addition, as described below, the proposal would make certain changes to the corporate and individual alternative minimum taxes.

Preference items in computing AMTI

The proposal would make the following changes to the minimum tax preference items:

(1) The preference relating to depletion would be repealed for depletion claimed in taxable years beginning after December 31, 2000.

(2) The preference relating to intangible drilling costs would be repealed for taxable years beginning after December 31, 2000.

(3) In the case of a corporation, the preference relating to tax-exempt interest on private activity bonds would be repealed for interest accruing after December 31, 2000.

In addition, the special rules relating to tax shelter farm activity and passive losses would be repealed for taxable years beginning after December 31, 2000.

Adjustments in computing AMTI

The proposal would make the following changes to the adjustments used in computing AMTI:

(1) The adjustment relating to depreciation would be repealed for property placed in service after December 31, 1997.

(2) The adjustment relating to mining exploration and development costs would be repealed for costs paid or incurred after December 31, 2000.

(3) The adjustment relating to long-term contracts would be repealed for contracts entered into after December 31, 2000.

(4) The adjustment relating to pollution control facilities would be repealed for property placed in service after December 31, 2000.

(5) The adjustment relating to installment sales would be repealed for dispositions after December 31, 2000.

(6) The adjustments relating to circulation and research and experimental expenditures would be repealed for costs paid or incurred after December 31, 2000.

(7) The adjustment relating to Merchant Marine capital construction funds would be repealed for deposits made to a fund after December 31, 2000, and to earnings received or accrued after December 31, 2000, on amounts in such funds. Withdrawals of deposits and earnings from a fund after December 31, 2000, would be treated as allocable: (a) first to deposits (and earnings received or accrued) before January 1, 1987; (b) then, to deposits (and earnings received or accrued) after December 31, 1986, and before January 1, 2001; and (c) then, to deposits (and earnings received or accrued) after December 31, 2000.

(8) The denial of the special deduction allowed under section 833(b) would be repealed for taxable years beginning after December 31, 2000.

Adjusted current earnings (ACE) adjustment

The proposal would make the following changes to the ACE adjustment of the corporate alternative minimum tax:

(1) The ACE rules relating to the inclusion (or deduction) of items included (or excluded) from the calculation of earnings and profits would not apply to taxable years beginning after December 31, 2000.

(2) The ACE adjustment relating to intangible drilling costs would be repealed for amounts paid or incurred after December 31, 2000.

(3) The ACE adjustment relating to section 173 and 248 costs would be repealed for amounts paid or incurred after December 31, 2000.

(4) The ACE adjustment relating to LIFO inventory would be repealed for LIFO adjustments arising in taxable years beginning after December 31, 2000.

(5) The ACE adjustment relating to installment sales would be repealed for sales after December 31, 2000.

(6) The ACE adjustment relating to the exchange of debt pools would be repealed for exchanges after December 31, 2000.

(7) The ACE adjustment relating to built-in losses with respect to certain changes of ownership would be repealed for ownership changes after December 31, 2000.

(8) The ACE adjustment relating to depletion would be repealed for depletion allowed in taxable years beginning after December 31, 2000.

Use of credits

The present-law rules that limit the use of the taxpayer's net operating loss carryovers and foreign tax credits to 90 percent of AMTI would be retained.

The proposal would not change the rules regarding the availability of other credits against the alternative minimum tax.

As under present law, in no event could alternative minimum tax credit carryovers be used to reduce the taxpayer's tax liability below its tentative minimum tax, if any. In addition, for taxable years beginning after December 31, 1997, alternative minimum tax credit carryovers may not reduce the taxpayer's regular tax liability by more than \$25,000, plus 75 percent of the taxpayer's regular tax liability in excess of \$25,000 (i.e., the present-law limitation applicable to the general business credit).

Effective Date

Except as provided above, the proposal would be effective for taxable years beginning after December 31, 1997.

V. ESTATE, GIFT, AND GENERATION-SKIPPING TAX PROVISIONS

A. Estate and Gift Tax Provisions

1. Increase in estate and gift tax unified credit

Present Law

A gift tax is imposed on lifetime transfers by gift and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.³⁴ A unified credit of \$192,800 is provided against the estate and gift tax, which effectively exempts the first \$600,000 in cumulative taxable transfers from tax (sec. 2010). For transfers in excess of \$600,000, estate and gift tax rates begin at 37 percent and reach 55 percent on cumulative taxable transfers over \$3 million (sec. 2001(c)). In addition, a 5-percent surtax is imposed upon cumulative taxable transfers between \$10 million and \$21,040,000, to phase out the benefits of the graduated rates and the unified credit (sec. 2001(c)(2)).³⁵

Description of Proposal

The proposal would increase the present-law unified credit beginning in 1998, from an effective exemption of \$600,000 to an effective exemption of \$1,000,000 in 2014. The increase in the effective exemption would be phased in in increments of \$20,000 per year for the first five years (1998-2002), then in increments of \$25,000 per year for the period 2003 to 2014. After 2014, the effective exemption would be indexed annually for inflation. The indexed exemption amount would be rounded to the next lowest multiple of \$10,000.

Conforming amendments to reflect the increased unified credit would be made (1) to the 5-percent surtax to conform the phase out of the increased unified credit and graduated rates, (2) to the general filing requirements for an estate tax return under section 6018(a), and (3) to the amount of the unified credit allowed under section 2102(c)(3) with respect to nonresident aliens with U.S. situs property who are residents of certain treaty countries.

³⁴ Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

³⁵ Thus, if a taxpayer has made cumulative taxable transfers equaling \$21,040,000 or more, his or her average transfer tax rate is 55 percent. The phaseout has the effect of creating a 60-percent marginal transfer tax rate on transfers in the phaseout range.

Effective Date

The proposal would be effective for decedents dying, and gifts made, after December 31, 1997.

2. Indexing of certain other estate and gift tax provisions

Present Law

Annual exclusion for gifts.--A taxpayer may exclude \$10,000 of gifts of present interests in property made by an individual (\$20,000 per married couple) to each donee during a calendar year (sec. 2503).

Special use valuation.--An executor may elect for estate tax purposes to value certain qualified real property used in farming or a closely-held trade or business at its current use value, rather than its "highest and best use" value (sec. 2032A). The maximum reduction in value under such an election is \$750,000.

Generation-skipping transfer ("GST") tax.--An individual is allowed an exemption from the GST tax of up to \$1,000,000 for generation-skipping transfers made during life or at death (sec. 2631).

Installment payment of estate tax.--An executor 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 (sec. 6166). The tax on the first \$1,000,000 in value of a closely-held business is eligible for a special 4-percent interest rate (sec. 6601(j)).

Description of Proposal

The proposal would provide that, after 1998, the \$10,000 annual exclusion for gifts, the \$750,000 ceiling on special use valuation, the \$1,000,000 generation-skipping transfer tax exemption, and the \$1,000,000 ceiling on the value of a closely-held business eligible for the special low interest rate (as modified below), would be indexed annually for inflation. Indexing of the annual exclusion would be rounded to the next lowest multiple of \$1,000 and indexing of the other amounts would be rounded to the next lowest multiple of \$10,000.

Effective Date

The proposal would be effective for decedents dying, and gifts made, after December 31, 1998.

3. Installment payments of estate tax attributable to closely held businesses

Present Law

In general, the Federal estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the 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 may pay only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest generally is 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 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.

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 determining the decedent's gross estate.

Description of Proposal

The proposal would extend the period for which Federal estate tax installments could be made under section 6166 to a maximum period of 24 years. If the election were made, the estate would pay only interest for the first four years, followed by up to 20 annual installments of principal and interest.

In addition, the proposal would provide that no interest would be imposed on the amount of deferred estate tax attributable to the first \$1,000,000 in taxable value of the closely held business (i.e., the first \$1,000,000 in value in excess of the effective exemption provided by the unified credit). Thus, for example, in 1998, when the unified credit is increased to provide an effective exemption of \$620,000 (as described above), the amount of estate tax attributable to the value of the closely held business between \$620,000 and \$1,620,000 would be eligible for the zero-percent interest rate.

The interest rate imposed on the amount of deferred estate tax attributable to the taxable value of the closely held business in excess of \$1,000,000 would be reduced to an amount equal to 45 percent of the rate applicable to underpayments of tax. The interest paid on estate taxes deferred under section 6166 would not be deductible for estate or income tax purposes.

Effective Date

The proposal would be effective for decedents dying after December 31, 1997.

4. Clarify eligibility for extension of time for payment of estate tax

Present Law

In general, the Federal estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the 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 may pay only interest for the first four years, followed by up to 10 annual installments of principal and interest. To qualify for the installment payment election, the business must meet certain requirements. If certain events occur during the repayment period (e.g., the closely held business is sold), full payment of all deferred estate taxes is required at that time.

Under present law, there is limited access to judicial review of disputes regarding initial or continuing eligibility for the deferral and installment election under section 6166. If the Commissioner determines that an estate was not initially eligible for deferral under section 6166, or has lost its eligibility for such deferral, the estate is required to pay the full amount of estate taxes asserted by the Commissioner as being owed in order to obtain judicial review of the Commissioner's determination.

Description of Proposal

The proposal would authorize the U.S. Tax Court to provide declaratory judgments regarding initial or continuing eligibility for deferral under section 6166.

Effective Date

The proposal would apply to decedents dying after date of enactment.

5. Estate tax recapture from cash leases of specially-valued property

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, such property is included in the decedent's estate at its fair market value. Under section 2032A, the executor may elect to value certain "qualified real property" used in farming or other qualifying trade or business at its current use value rather than its highest and best use. If, after the special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's

death, an additional estate tax is imposed in order to "recapture" the benefit of the special-use valuation (sec. 2032A(c)).

Some courts have held that cash rental of specially-valued property after the death of the decedent is not a qualified use under section 2032A because the heirs no longer bear the financial risk of working the property, and, therefore, results in the imposition of the additional estate tax under section 2032A(c). See Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party not qualified use); Williamson v. Commissioner, 93 T.C. 242 (1989), aff'd, 974 F.2d 1525 (9th Cir. 1992) (cash lease to family member not a qualified use); Fisher v. Commissioner, 65 T.C.M. 2284 (1993) (cash lease to family member not a qualified use); cf. Minter v. U.S., 19 F.3d 426 (8th Cir. 1994) (cash lease to family's farming corporation is qualified use); Estate of Gavin v. U.S., 1997 U.S. App. Lexis 10383 (8th Cir. 1997) (heir's option to pay cash rent or 50 percent crop share is qualified use).

With respect to a decedent's surviving spouse, a special rule provides that the surviving spouse will not be treated as failing to use the property in a qualified use solely because the spouse rents the property to a member of the spouse's family on a net cash basis. (sec. 2032A(b)(5)). Under section 2032A, members of an individual's family include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants.

Description of Proposal

The proposal would provide that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

Effective Date

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

6. Gifts may not be revalued for estate tax purposes after expiration of statute of limitations

Present Law

The Federal estate and gift taxes are unified so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The tax on gifts made in a particular year is computed by determining the tax on the sum of the taxable gifts made that year and all prior years and then subtracting the tax on the prior years taxable gifts and the unified credit. Similarly, the estate tax is computed by determining the tax on the sum of the taxable estate and prior taxable gifts and then subtracting the tax on taxable gifts and the unified credit. Under a

special rule applicable to the computation of the gift tax (sec. 2504(c)), the value of gifts made in prior years is the value that was used to determine the prior year's gift tax. There is no comparable rule in the case of the computation of the estate tax.

Generally, any estate or gift tax must be assessed within three years after the filing of the return. No proceeding in a court for the collection of an estate or gift tax can be begun without an assessment within the three-year period. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time. If an estate or gift tax return is filed, and the amount of unreported items exceeds 25 percent of the amount of the reported items, the tax may be assessed or a suit commenced to collect the tax without assessment, within six years after the return was filed (sec. 6501).

Commencement of the statute of limitations generally does not require that a particular gift be disclosed. A special rule, however, applies to certain gifts that are valued under the special valuation rules of Chapter 14. The gift tax statute of limitations runs for such a gift only if it is disclosed on a gift tax return in a manner adequate to apprise the Secretary of the Treasury of the nature of the item.

Most courts have permitted the Commissioner to redetermine the value of a gift for which the statute of limitations period for the gift tax has expired in order to determine the appropriate tax rate bracket and unified credit for the estate tax. See, e.g., Evanson v. United States, 30 F.3d 960 (9th Cir. 1994); Stalcup v. United States, 946 F. 2d 1125 (5th Cir. 1991); Estate of Levin, 1991 T.C. Memo 1991-208, aff'd 986 F. 2d 91 (4th Cir. 1993); Estate of Smith v. Commissioner, 94 T.C. 872 (1990). But see Boatman's First National Bank v. United States, 705 F. Supp. 1407 (W.D. Mo. 1988) (Commissioner not permitted to revalue gifts).

Description of Proposal

The proposal would provide that a gift for which the limitations period has passed cannot be revalued for purposes of determining the applicable estate tax bracket and available unified credit. For gifts made after the date of enactment, the proposal also would extend the special rule governing gifts valued under Chapter 14 to all gifts. Thus, the statute of limitations would not run on an inadequately disclosed transfer after the date of enactment, regardless of whether a gift tax return was filed for other transfers in that same year.

Effective Date

The proposal generally would apply to gifts made after the date of enactment. The extension of the special rule under chapter 14 to all gifts would apply to gifts made in calendar years after the date of enactment.

7. Repeal of throwback rules applicable to domestic trusts

Present Law

Under present law, income which is accumulated in a trust is taxable to the trust instead of its beneficiaries. Trusts are subject to their own set of tax rates which historically has permitted trust income to be taxed at lower rates than the rates applicable to its beneficiaries. This benefit often was compounded through the creation of multiple trusts. The Internal Revenue Code has a series of rules to limit the benefit that would otherwise occur from using the lower rates applicable to one or more trusts. Under the so-called "throwback" rules, the distribution of previously accumulated trust income to a beneficiary will be subject to tax (in addition to any tax paid by the trust on that income) where the beneficiary's average top marginal rate in the previous five years is higher than those of the trust.

Under section 643(f), two or more trusts are treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is to avoid Federal income tax. For trusts that were irrevocable as of March 1, 1984, section 643(f) applies only to contributions to corpus after that date.

Under section 644, if property is sold within two years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property is taxed at the contributor's marginal tax rates. In effect, section 644 treats such gains as if the contributor had realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.

Description of Proposal

The proposal would repeal the throwback rules for amounts distributed by a domestic trust. The proposal also would provide that pre-contribution gain on property sold by a domestic trust no longer would be subject to section 644 (i.e., taxed at the contributor's marginal tax rates).

Effective Date

The proposal with respect to the throwback rules would be effective for distributions made in taxable years beginning after the date of enactment. The modification to section 644 would apply to sales or exchanges after the date of enactment.

8. Unified credit of decedent increased by unified credit of spouse used on split gift included in decedent's gross estate

Present Law

A gift tax is imposed on transfers by gift during life and an estate tax is imposed on transfers at death. The gift and estate taxes are a unified transfer tax system in that one progressive tax is imposed on the cumulative transfers during the lifetime and at death. The amount of gift tax payable for any taxable period generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period. Also, the first \$10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer and then subtracting any transfer taxes payable for prior taxable periods. This amount is reduced by any remaining available unified credit (and other applicable credits) to determine the estate tax liability. The estate tax is imposed on all of the assets held by the decedent at his death, including the value of property previously transferred by the decedent in which the decedent had certain retained powers or interests (e.g., sections 2036 (relating to transfers with retained life estate), 2037 (relating to transfers taking effect at death), 2038 (relating to revocable trusts), or 2042 (relating to proceeds of life insurance)). Under section 2035, the estate tax also would apply with respect to property in which such a retained power or interest is transferred within three years of death.

Under section 2513, one spouse can elect to treat a gift made by the other spouse to a third person as made one-half by each spouse (i.e., "gift-splitting"). This effectively permits the transferor taxpayer to benefit from any annual exclusion, unified credit and lower gift tax brackets allowable to the non-transferor spouse. These tax benefits of gift-splitting, however, will be lost in circumstances where the split-gift property is subsequently included in the transferor spouse's estate under section 2035 (i.e., the transferor spouse dies within three years of the date of the transfer and the transferor spouse had retained sufficient interests such that the entire transferred interest is includible in the transferor's estate).

Description of Proposal

With respect to any split-gift property that is subsequently included in the estate of the transferor spouse under section 2035, the proposal would increase the unified credit allowable to his or her estate by the amount of the unified credit previously allowed to the nontransferor spouse with respect to the split gift.

Effective Date

The proposal would apply to gifts made after the date of enactment.

9. Reformation of defective bequests to spouse of decedent

Present Law

A "marital deduction" generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. However, "terminable interest" property (i.e., an interest in property that will terminate or fail) transferred to a spouse generally will only qualify for the marital deduction under certain special rules designed to ensure that there will be an estate or gift tax to the transferee spouse on unspent transferred proceeds. Thus, the effect of a marital deduction with the terminable interest rule is to provide only a method of deferral of the estate or gift tax, not exemption. One of the special terminable interest rules (Code sec. 2056(b)(5)) provides that the marital deduction is allowed where the decedent transfers property to a trust that is required to pay income to the surviving spouse and the surviving spouse has a general power of appointment at that spouse's death (under this so-called "power of appointment trust," the power of appointment both provides the surviving spouse with power to control the ultimate disposition of the trust assets and assures that the trust assets will be subject to estate or gift tax). Another special terminable interest rule called the "qualified terminable interest property" rule ("QTIP") permits a marital deduction for transfers to a trust that is required to distribute income to the surviving spouse if an election is made to subject the transferee spouse to transfer tax on the trust property. To qualify for the marital deduction, a power of appointment trust or QTIP trust must meet certain specific requirements. If there is a technical defect in meeting those requirements, the marital deduction may be lost.

Description of Proposal

The proposal would allow the marital deduction with respect to a defective trust if there is a "qualified reformation" of the trust that corrects the defect. In order to qualify, the reformation must change the governing instrument in a manner that cures the defects to qualification of the trust for the marital deduction. In addition, where a reformation proceeding is commenced after the due date for the estate tax return (including extensions), the reformation would qualify only if, prior to reformation, the governing instrument provides (1) that the surviving spouse is entitled to all of the income from the property for life, and (2) no person other than the surviving spouse is entitled to any distributions during the surviving spouse's life.

Effective Date

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

B. Generation-Skipping Tax Provisions

1. Severing of trusts holding property having an inclusion ratio of greater than zero

Present Law

A generation-skipping transfer tax ("GST" tax) generally is imposed on transfers, either directly or through a trust or similar arrangement, to a skip person (i.e., a beneficiary in more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions. An exemption of \$1 million is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

If the value of the transferred property exceeds the amount of the GST exemption allocated to that property, the GST tax generally is determined by multiplying a flat rate equal to the highest estate tax rate (i.e., currently 55 percent) by the "inclusion percentage" and the value of the taxable property at the time of the taxable event. The "inclusion percentage" is the number one minus the "exclusion percentage." The exclusion percentage generally is calculated by dividing the amount of the GST exemption allocated to the property by the value of the property.

Description of Proposal

If a trust with an inclusion ratio of greater than zero is severed into two separate trusts, the proposal would allow the trustee to elect to treat one of the separate trusts as having an inclusion ratio of zero and the other separate trust as having an inclusion ratio of one. To qualify for this treatment, the separate trust with the inclusion ratio of one must receive an interest in each property held by the single trust (prior to severance) equal to the single trust's inclusion ratio, except to the extent otherwise provided by regulation. The remaining interests in each property would be transferred to the separate trust with the inclusion ratio of zero. The election must be made at a time and in a manner prescribed by the Treasury Department.

Effective Date

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

2. Modification of generation-skipping transfer tax for transfers to individuals with deceased parents

Present Law

Under the "predeceased parent exception," a direct skip transfer to a transferor's grandchild is not subject to the generation skipping transfer ("GST") tax if the child of the

transferor who was the grandchild's parent is deceased at the time of the transfer (sec. 2612(c)(2)). This "predeceased parent exception" to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

Description of Proposal

The proposal would extend the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. In addition, the proposal would extend the predeceased parent exception (as modified by the preceding sentence) to certain taxable terminations and taxable distributions.

Effective Date

The proposal would be effective for generation skipping transfers occurring after December 31, 1997.

VI. EXTENSION OF CERTAIN EXPIRING TAX PROVISIONS

A. Research Tax Credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally will not apply to amounts paid or incurred after May 31, 1997.³⁶

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

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.³⁷

³⁶ When originally enacted, the research tax credit applied to qualified expenses incurred after June 30, 1981. The credit was modified several times and was extended through June 30, 1995. The credit later was extended for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime).

³⁷ The Small Business Job Protection Act of 1996 expanded the definition of "start-up firms" under section 41(c)(3)(B)(I) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.

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

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

Alternative incremental research credit regime

As part of the Small Business Job Protection Act of 1996, taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made only for a taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of

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

the Secretary of the Treasury. If a taxpayer elects the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, then all qualified research expenses paid or incurred during the first 11 months of such taxable year are treated as qualified research expenses for purposes of computing the taxpayer's credit.

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").³⁸

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

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

³⁸ Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized. However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

The research tax credit would be extended for the period June 1, 1997, through December 31, 1998.

Under the proposal, taxpayers would be permitted to elect the alternative incremental research credit regime under section 41(c)(4) for any taxable year, and such election would apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

Effective Date

The proposal would be effective for expenditures paid or incurred during the period June 1, 1997, through December 31, 1998.

B. Contributions of Stock to Private Foundations

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.³⁹ However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.⁴⁰

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to May 31, 1997.⁴¹ Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

³⁹ The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)).

⁴⁰ As part of the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, if a taxpayer makes a gift to charity of property (other than short-term gain, inventory, or other ordinary income property, or gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim the same fair-market-value deduction for both regular tax and AMT purposes (subject to present-law percentage limitations).

⁴¹ The special rule contained in section 170(e)(5), which was originally enacted in 1984, expired January 1, 1995. The Small Business Job Protection Act of 1996 reinstated the rule for 11 months--for contributions of qualified appreciated stock made to private foundations during the period July 1, 1996, through May 31, 1997.

Description of Proposal

The proposal would extend the special rule contained in section 170(e)(5) for one year -- for contributions of qualified appreciated stock made to private foundations during the period June 1, 1997, through December 31, 1998.

Effective Date

The provision would be effective for contributions of qualified appreciated stock to private foundations made during the period June 1, 1997, through December 31, 1998.

C. Work Opportunity Tax Credit

Present Law

In general

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of seven targeted groups. The credit generally is equal to 35 percent of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

Generally, no more than \$6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is \$2,100. With respect to qualified summer youth employees, the maximum credit is 35 percent of up to \$3,000 of qualified first-year wages, for a maximum credit of \$1,050.

The deduction for wages is reduced by the amount of the credit.

Targeted groups eligible for the credit

(1) Families receiving AFDC

An eligible recipient is an individual certified by the designated local employment agency as being a member of a family eligible to receive benefits under AFDC or its successor program for a period of at least nine months part of which is during the 9-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the AFDC or its successor program.

(2) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law, (2) being a member of a family that had an income during the six months before the earlier of the date of determination or the hiring date which on an annual basis is 70 percent or less of the Bureau of Labor Statistics lower living standard, and (3) having a hiring date within one year of release from prison or date of conviction.

(3) High-risk-youth

A high-risk youth is an individual certified as being at least 18 but not 25 on the hiring date and as having a principal place of abode within an empowerment zone or enterprise

community (as defined under Subchapter U of the Internal Revenue Code). Qualified wages will not include wages paid or incurred for services performed after the individual moves outside an empowerment zone or enterprise community.

(4) Vocational rehabilitation referral

Vocational rehabilitation referrals are those individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a State plan approved under the Rehabilitation Act of 1973 or under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(5) Qualified summer youth employee

Qualified summer youth employees are individuals: (1) who perform services during any 90-day period between May 1 and September 15, (2) who are certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who have not been an employee of that employer before, and (4) who are certified by the designated local agency as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). As with high-risk youths, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone or enterprise community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(6) Qualified veteran

A qualified veteran is a veteran who is a member of a family certified as receiving assistance under: (1) AFDC for a period of at least nine months part of which is during the 12-month period ending on the hiring date, or (2) a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for: (i) the AFDC or its successor program, and (ii) a food stamp program under the Food Stamp Act of 1977, respectively.

Further, a qualified veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on

active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(7) Families receiving food stamps

An eligible recipient is an individual aged 18 but not 25 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

Minimum employment period

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 400 hours (120 hours in the case of a qualified summer youth employee).

Expiration date

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.

Description of Proposal

The proposal would extend for one year the work opportunity tax credit.

Effective Date

The proposal to extend the work opportunity tax credit would be effective for wages paid or incurred to qualified individuals who begin work for the employer after September 30, 1997, and before October 1, 1998.

D. Orphan Drug Tax Credit

Present Law

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

As with other general business credits (sec. 38), taxpayers are allowed to carry back unused credits to three years preceding the year the credit is earned (but not to a taxable year ending before July 1, 1996) and to carry forward unused credits to 15 years following the year the credit is earned. The credit cannot be used to offset a taxpayer's alternative minimum tax liability.

The orphan drug tax credit expired and does not apply to expenses paid or incurred after May 31, 1997.⁴²

Description of Proposal

The orphan drug tax credit would be permanently extended.

Effective Date

The proposal would be effective for qualified clinical testing expenses paid or incurred after May 31, 1997.

⁴² The orphan drug tax credit originally was enacted in 1983 and was extended on several occasions. The credit expired on December 31, 1994, and later was reinstated for the period July 1, 1996, through May 31, 1997.

VII. DISTRICT OF COLUMBIA TAX INCENTIVES

Present Law

Empowerment zones and enterprise communities

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.⁴³ 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). Portions of the District of Columbia were designated as an enterprise community.

The following tax incentives are available for certain businesses located in empowerment zones: (1) an annual 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 expensing under Code section 179 for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to \$38,000 of expensing for 1997; the allowable amount will increase to \$38,500 for 1998); 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.

⁴³ 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, and Wayne counties, Kentucky), Mid-Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Mississippi), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, and Willacy counties, Texas).

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, however, 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 the greater of 100 percent of the taxpayer's basis in the property at the beginning of the period, or \$5,000.

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.⁴⁴ 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.

⁴⁴ 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.

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 "enterprise zone business" (also defined above⁴⁵), 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.

Taxation of capital gains

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain generally is taxed at the same rate as ordinary income, except that the maximum rate of tax is limited to 28 percent of the net capital gain.⁴⁶ Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to \$3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified

⁴⁵ 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.

⁴⁶ The Revenue Reconciliation Act of 1993 added Code section 1202, which provides a 50-percent exclusion for gain from the sale of certain small business stock acquired at original issue and held for at least five years.

literary or artistic property, (4) business accounts or notes receivable, and (5) certain publications of the Federal Government.

In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property generally is not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method.

Individual tax rates

To determine tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 1997, the individual income tax rate schedules are as follows:

If taxable income is

Then income tax equals

Single individuals

\$0-\$24,650	15 percent of taxable income
\$24,651-\$59,750	\$3,698, plus 28% of the amount over \$24,650
\$59,751-\$124,650	\$13,526, plus 31% of the amount over \$59,750
\$124,651-\$271,050	\$33,645, plus 36% of the amount over \$124,650
Over \$271,050	\$86,349, plus 39.6% of the amount over \$271,050

Heads of households

\$0-\$33,050	15 percent of taxable income
\$33,051-\$85,350	\$4,958, plus 28% of the amount over \$33,050
\$85,351-\$138,200	\$19,602 plus 31% of the amount over \$85,350
\$138,201-\$271,050	\$35,985, plus 36% of the amount over \$138,200
Over \$271,050	\$83,811, plus 39.6% of the amount over \$271,050

Married individuals filing joint returns

\$0-\$41,200	15 percent of taxable income
\$41,201-\$99,600	\$6,180, plus 28% of the amount over \$41,200
\$99,601-\$151,750	\$22,532, plus 31% of the amount over \$99,600

\$151,751- \$271,050	\$38,698, plus 36% of the amount over \$151,750
Over \$271,050	\$81,646, plus 39.6% of the amount over \$271,050

Married individuals filing separate returns

\$0-\$20,600	15 percent of taxable income
\$20,601-\$49,800	\$3,090, plus 28% of the amount over \$20,600
\$49,801-\$75,875	\$11,266, plus 31% of the amount over \$49,800
\$75,876- \$135,525	\$19,349, plus 36% of the amount over \$75,875
Over \$135,525	\$40,823 plus 39.6% of the amount over \$135,525

Description of Proposal

Designation of D.C. Enterprise Zone

Certain economically depressed census tracts within the District of Columbia would be designated as the "D.C. Enterprise Zone," within which businesses and individual residents would be eligible for special tax incentives. The census tracts that would compose the D.C. Enterprise Zone would be (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District) and (2) all additional census tracts within the District of Columbia where the poverty rate is at least 35 percent. The D.C. Enterprise Zone designation generally would remain in effect for five years for the period from January 1, 1998, through December 31, 2002.⁴⁷

The following tax incentives would take effect only if, prior to January 1, 1998, a Federal law is enacted creating a District of Columbia economic development corporation that is an instrumentality of the District of Columbia government.⁴⁸

Business development incentives

Empowerment zone wage credit, expensing, and tax-exempt financing

Qualified D.C. Enterprise Zone businesses (defined as enterprise zone businesses under present-law section 1397B) located in any census tract that is part of the D.C. Zone would be

⁴⁷ The status of certain census tracts within the District as an enterprise community designated under section 1391 also would terminate on December 31, 2002.

⁴⁸ In addition, the proposal assumes the enactment of certain modifications to Federal law (other than Federal tax laws contained in the Internal Revenue Code) similar to those proposed by the Administration that would clarify and expand the District's authority to issue revenue bonds.

eligible for tax incentives that are available under present law for empowerment zones (modified as described below): (1) a 20-percent wage credit for the first \$15,000 of wages paid to D.C. Enterprise Zone residents who work in the D.C. Enterprise Zone; (2) an additional \$20,000 of expensing under Code section 179 for qualified zone property; and (3) special tax-exempt financing for certain zone facilities.

In general, the wage credit for certain D.C. Enterprise Zone residents who work in the D.C. Enterprise Zone would be the same as is available in empowerment zones under present law. However, the wage credit rate would remain at 20 percent for the D.C. Enterprise Zone for the period 1998 through 2002 (and would not phase down to 15 percent in the year 2002 as under present-law section 1396). The wage credit would be effective for wages paid (or incurred) to a qualified individual who begins work for an employer after December 31, 1997, and before January 1, 2003.

The increased expensing under Code section 179 would be effective for property placed in service in taxable years beginning after December 31, 1997, and before January 1, 2003. Thus, qualified D.C. Enterprise Zone property placed in service in taxable years beginning in 1998 would be eligible for up to \$38,500 of expensing.

A qualified D.C. Enterprise Zone business (defined as under present law section 1394(b)(3)) would be permitted to borrow proceeds from the issuance of qualified enterprise zone facility bonds. Such bonds could be issued only by a newly created economic development corporation and would be subject to the requirements applicable under present law to enterprise zone facility bonds, except that the amount of outstanding bond proceeds that could be borrowed by any qualified District business could not exceed \$15 million (rather than \$3 million). The special tax-exempt bond provisions would apply to bonds issued after December 31, 1997, and prior to January 1, 2003.

Tax credits for equity investments in and loans to businesses located in the District of Columbia

A newly created economic development corporation would be authorized to allocate \$75 million in tax credits to taxpayers that make certain equity investments in, or loans to, businesses (either corporations or partnerships) engaged in an active trade or business in the District of Columbia. The business need not be located in the D.C. Enterprise Zone, although factors to be considered in the allocation of credits would include whether the project would provide job opportunities for low and moderate income residents of the D.C. Enterprise Zone and whether the business is located in the D.C. Enterprise Zone. Eligible businesses would not be required to satisfy the criteria of a qualified D.C. Enterprise Zone business, described above. Such credits would be nonrefundable and could be used to offset a taxpayer's alternative minimum tax (AMT) liability.

Under the proposal, the amount of credit could not exceed 25 percent of the amount invested (or loaned) by the taxpayer. Thus, the economic development corporation could

allocate the full \$75 million in tax credits to no less than \$300 million in equity investments in, or loans, to eligible businesses.

Under the proposal, credits could be allocated to loans made to an eligible business only if the business uses the loan proceeds to purchase depreciable tangible property and any functionally related and subordinate land. Credit could be allocated to equity investments only if the equity interest was acquired for cash. Any credits allocated to a taxpayer making an equity investment would be subject to recapture if the equity interest is disposed of by the taxpayer within five years. A taxpayer's basis in an equity investment would be reduced by the amount of the credit.

The proposal would apply to credit amounts allocated for taxable years beginning after December 31, 1997, and before January 1, 2003.⁴⁹

Zero percent capital gains rate

The proposal would provide a zero percent capital gains rate for capital gains from the sale of certain qualified D.C. Zone assets held for more than five years. In general, D.C. Enterprise Zone assets mean stock or partnership interests held in or tangible property held by a D.C. Enterprise Zone business. For this purpose, a D.C. Enterprise Zone business would be defined as an enterprise zone business under present-law section 1397B.

"D.C. Enterprise Zone business stock" would be stock in a domestic corporation originally issued after December 31, 1997, that, at the time of issuance⁵⁰ and during substantially all of the taxpayer's holding period, was a D.C. Enterprise Zone business, provided that such stock was acquired by the taxpayer on original issue from the corporation solely in exchange for cash.⁵¹ A "D.C. Enterprise Zone partnership interest" would be a domestic partnership interest originally issued after December 31, 1997, that is acquired by the taxpayer from the partnership solely in exchange for cash before January 1, 2003, provided that, at the time such interest was acquired⁵² and during substantially all of the taxpayer's holding period, the partnership was a

⁴⁹ As a general business credit, the credit could be carried back three years (but not before January 1, 1998) and forward for fifteen years.

⁵⁰ In the case of a new corporation, it would be sufficient if the corporation is being organized for purposes of being a D.C. Enterprise Zone business.

⁵¹ Qualified D.C. Enterprise Zone business stock would not include any stock acquired from a corporation which made a substantial stock redemption or distribution (without a bona fide business purpose therefore) in an attempt to avoid the purposes of the provision. A similar rule also would apply with respect to qualified D.C. Zone partnership interests.

⁵² In the case of a new partnership, it would be sufficient if the partnership is being formed for purposes of being a D.C. Zone business.

D.C. Enterprise Zone business. Finally, "D.C. Enterprise Zone business property" would be tangible property acquired by the taxpayer by purchase (within the meaning of present law section 179(d)(2)) after December 31, 1997, and before January 1, 2003, provided that the original use of such property in the D.C. Enterprise Zone commences with the taxpayer and substantially all of the use of such property during substantially all of the taxpayer's holding period was in a D.C. Enterprise Zone business of the taxpayer.

A special rule would provide that, in the case of business property that is "substantially renovated," such property need not be acquired by the taxpayer after December 31, 1997, nor need the original use of such property in the D.C. Enterprise Zone commence with the taxpayer. For these purposes, property is treated as "substantially renovated" if, prior to January 1, 2003, additions to basis with respect to such property in the hands of the taxpayer during any 24-month period beginning after December 31, 1997, exceed the greater of (1) an amount equal to the adjusted basis at the beginning of such 24-month period in the hands of the taxpayer, or (2) \$5,000. Thus, substantially renovated real estate located in the D.C. Enterprise Zone may constitute D.C. Enterprise Zone business property. However, the proposal specifically would exclude land that is not an integral part of a D.C. Enterprise Zone business from the definition of D.C. Enterprise Zone business property.

In addition, qualified D.C. Enterprise Zone assets would include property that was a qualified D.C. Enterprise Zone asset in the hands of a prior owner, provided that at the time of acquisition, and during substantially all of the subsequent purchaser's holding period, either (1) substantially all of the use of the property is in a D.C. Enterprise Zone business, or (2) the property is an ownership interest in a D.C. Enterprise Zone business.⁵³

In general, gain eligible for the zero percent tax rate would mean gain from the sale or exchange of a qualified D.C. Enterprise Zone asset that is (1) a capital asset or (2) property used in the trade or business as defined in section 1231(b). Gain attributable to periods before December 31, 1997, and after December 31, 2007, would not be qualified capital gain. No gain attributable to real property, or an intangible asset, which is not an integral part of a D.C. Enterprise Zone business would qualify for the zero percent rate.

The proposal would provide that property that ceases to be a qualified D.C. Enterprise Zone asset because the property is no longer used in (or no longer represents an ownership interest in) a D.C. Enterprise Zone business after the five-year period beginning on the date the taxpayer acquired such property would continue to be treated as a D.C. Enterprise Zone asset. Under this rule, the amount of gain eligible for the zero percent capital gains rate could not

⁵³ The termination of the D.C. Enterprise Zone designation would not, by itself, result in property failing to be treated as a qualified D.C. Enterprise Zone asset. However, capital gain eligible for the zero percent capital gains rate does not include any gain attributable to periods after December 31, 2007.

exceed the amount which would be qualified capital gain had the property been sold on the date of such cessation.

Special rules would be provided for pass-through entities (i.e., partnerships, S corporations, regulated investment companies, and common trust funds). In the case of a sale or exchange of an interest in a pass-through entity that was not a D.C. Enterprise Zone business during substantially all of the period that the taxpayer held the interest, the zero percent capital gains rate would apply to the extent that the gain is attributable to amounts that would have been qualified capital gain had the assets been sold for their fair market value on the date of the sale or exchange of the interest in the pass-through entity. This rule would apply only if the interest in the pass-through entity were held by the taxpayer for more than five years. In addition, the rule would apply only to qualified D.C. Enterprise Zone assets that were held by the pass-through entity for more than five years, and throughout the period that the taxpayer held the interest in the pass-through entity.

The proposal also would provide that in the case of a transfer of a qualified D.C. Enterprise Zone asset by gift, at death, or from a partnership to a partner that held an interest in the partnership at the time that the qualified D.C. Enterprise Zone asset was acquired, (1) the transferee is to be treated as having acquired the asset in the same manner as the transferor, and (2) the transferee's holding period includes that of the transferor. In addition, rules similar to those contained in section 1202(i)(2) regarding treatment of contributions to capital after the original issuance date and section 1202(j) regarding treatment of certain short positions would apply.

Individual resident tax rate reduction

Individuals who have their principal place of abode in any census tract that is part of the D.C. Enterprise Zone would be entitled to a 10-percent tax rate on all taxable income that currently is subject to a 15-percent Federal income tax rate. Thus, using the 1997 tax rate schedule, a single taxpayer who resides in the D.C. Enterprise Zone with \$24,650 or more of taxable income would receive a Federal income tax reduction of \$1,233 under the proposal. Married taxpayers who reside in the D.C. Enterprise Zone and file a joint return with taxable income of \$41,200 or more of taxable income would receive a Federal income tax reduction of \$2,060 under the proposal.

The special 10-percent rate provision would be in effect for the period 1998-2007.

Effective Date

The D.C. tax proposals generally would be effective January 1, 1998, and would remain in effect for five years until the termination of the D.C. Enterprise Zone designation on December 31, 2002. However, the zero percent tax rate for capital gains and the special 10-percent rate bracket would be effective for the period 1998-2007.

VIII. WELFARE-TO-WORK TAX CREDIT

Present Law

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of seven targeted groups. The credit generally is equal to 35 percent of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

For purposes of the work opportunity tax credit, the targeted groups for which the credit is available include (1) families receiving Aid to Families with Dependent Children (AFDC), (2) qualified ex-felons, (3) high-risk youth, (4) vocational rehabilitation referrals, (5) qualified summer youth employees, (6) qualified veterans, and (7) families receiving food stamps.

Generally, no more than \$6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is \$2,100. With respect to qualified summer youth employees, the maximum credit is 35 percent of up to \$3,000 of qualified first-year wages, for a maximum credit of \$1,050.

The deduction for wages is reduced by the amount of the credit.

The work opportunity tax credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.

Description of Proposal

The proposal would provide to employers a credit on the first \$20,000 of eligible wages paid to qualified long-term family assistance (AFDC or its successor program) recipients during the first two years of employment. The credit would be 35 percent of the first \$10,000 of eligible wages in the first year of employment and 50 percent of the first \$10,000 of eligible wages in the second year of employment. The maximum credit would be \$8,500 per qualified employee.

Qualified long-term family assistance recipients would include: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after the date of enactment of this credit if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are

hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Eligible wages would include amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of section 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)(4); and (3) dependent care assistance excludable under section 129.

Effective Date

The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998 and before October 1, 2000.

IX. MISCELLANEOUS PROVISIONS

A. Provisions Relating to Excise Taxes

1. Vaccine excise tax provisions

a. Exempt Federal vaccine purchases from vaccine excise tax for one year

Present Law

Under present law, a manufacturer's excise tax is imposed on the following vaccines routinely recommended for administration to children: DPT, \$4.56 per dose; DT, \$0.06 per dose; MMR, \$4.44 per dose; and polio, \$0.29 per dose. Any component vaccine of MMR (measles, mumps, or rubella) is taxed at the same rate as the MMR combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1998, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal would exempt vaccine purchases paid through grants from the Centers for Disease Control and Prevention and the Health Care Financing Administration from the vaccine excise tax for a one-year period.

Effective Date

The proposal would be effective for vaccine purchases after September 30, 1997, and before September 30, 1998.

b. Modify rate structure of vaccine excise tax

Present Law

Under section 4131, a manufacturer's excise tax is imposed on the following vaccines routinely recommended for administration to children: DPT (diphtheria, pertussis, tetanus), \$4.56 per dose; DT (diphtheria, tetanus), \$0.06 per dose; MMR (measles, mumps, or rubella), \$4.44 per dose; and polio, \$0.29 per dose. In general, if any vaccine is administered by combining more than one of the listed taxable vaccines, the amount of tax imposed is the sum of

the amounts of tax imposed for each taxable vaccine. However, in the case of MMR and its components, any component vaccine of MMR is taxed at the same rate as the MMR combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1998, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal would replace the present-law excise tax rates, that differ by vaccine, with a single rate tax of \$0.84 per dose on any listed vaccine component. Thus, the proposal would provide that the tax applied to any vaccine that is a combination of vaccine components would be 84 cents times the number of components in the combined vaccine. For example, the MMR vaccine would be taxed at a rate of \$2.52 per dose and the DT vaccine would be taxed at rate of \$1.68 per dose.

In addition, the proposal would add three new taxable vaccines to the present-law taxable vaccines: (1) HIB (haemophilus influenza type B); (2) Hepatitis B; and (3) varicella (chickenpox). The three newly listed vaccines also would be subject to the 84-cents per dose excise tax.

Effective Date

The proposal would be effective for vaccine purchases after September 30, 1997. No tax would be collected or refunds permitted for amounts held for sale on October 1, 1997.

2. Repeal excise tax on diesel fuel used in recreational motorboats

Present Law

Before a temporary suspension through December 31, 1997 was enacted in 1996, diesel fuel used in recreational motorboats was subject to the 24.3-cents-per-gallon diesel fuel excise tax. Revenues from this tax were retained in the General Fund. The tax was enacted by the Omnibus Budget Reconciliation Act of 1993 as a revenue offset for repeal of the excise tax on certain luxury boats.

Description of Proposal

The proposal would repeal the application of the diesel fuel tax to fuel used in recreational motorboats.

Effective Date

The proposal would be effective for fuel sold after December 31, 1997.

3. Modifications to excise tax on ozone-depleting chemicals relating to imported halons

Present Law

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (Code sec. 4681). The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount is \$6.25 per pound in 1997 and will increase by 45 cents per pound per year thereafter. The ozone-depleting factors for taxable halons are 3 for halon-1211, 10 for halon-1301, and 6 for halon-2402.

Taxable chemicals that are recovered and recycled within the United States are exempt from tax. In addition, exemption is provided for imported recycled halon-1301 and halon-2402 if such chemicals are imported from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer. Present law further provides that exemption is to be provided for imported recycled halon-1211, for such chemicals imported from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer after December 31, 1997.

Description of Proposal

The proposal would repeal the present-law exemption for imported recycled halon-1211.

Effective Date

The proposal would be effective on the date of enactment.

B. Disaster Relief Provisions

1. Treasury authority to issue guidance relating to disaster relief

Present Law

Authority to postpone certain tax-related deadlines

In the case of a Presidentially declared disaster, the Secretary of the Treasury has the authority to postpone some (but not all) tax-related deadlines.

Appraisals

In order to claim a disaster loss, a taxpayer must establish the amount of the loss. This may, for example, be done through the use of an appraisal.

Description of Proposals

Authority to postpone certain tax-related deadlines

The proposal would provide that, in the case of a taxpayer determined to be affected by a Presidentially declared disaster, the Secretary may specify that, for a period of up to 90 days, certain taxpayer deadlines are postponed. The deadlines that may be postponed are the same as are postponed by reason of service in a combat zone. The proposal would not apply for purposes of determining interest on any overpayment or underpayment.

Appraisals

The proposal would provide that nothing in the Code should be construed to prohibit Treasury from issuing guidance providing that an appraisal for the purpose of obtaining a Federal loan or Federal loan guarantee as the result of a Presidentially declared disaster may be used to establish the amount of a disaster loss.

Effective Date

Authority to postpone certain tax-related deadlines

The proposal would be effective for any period for performing an act that has not expired before the date of enactment.

Appraisals

The proposal would be effective on the date of enactment.

2. Treatment of livestock sold on account of weather-related conditions

Present Law

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, present law contains two special rules applicable to livestock sold on account of drought conditions. Code section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the drought.

In addition, the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under section 1033(e). Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

Description of Proposal

The proposal would amend Code section 451(e) to provide that a cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock due not only to drought (as under present law), but also to floods or other weather-related conditions, may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income would be available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for the drought, flood or other weather-related conditions that resulted in the area being designated as eligible for Federal assistance.

In addition, the proposal would amend Code section 1033(e) to provide that the sale of livestock (other than poultry) that are held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought (as under present law), flood or other weather-related conditions is treated as an involuntary conversion.

Effective Date

The proposal would apply to sales and exchanges after December 31, 1996.

C. Provisions Relating to Employment Taxes

1. Employment tax status of distributors of bakery products

Present Law

Under present law, the determination of whether a worker is an employee or an independent contractor is generally determined under a common-law facts and circumstances test. An employer-employee relationship generally exists if the person contracting for the services has the right to control not only the result of the services, but also the means by which that result is accomplished.

Under a special statutory rule, bakery distributors are treated as employees for Social Security payroll tax purposes if: (1) their services are part of a continuing relationship with the person for whom they are performed; (2) the distributor's service contract contemplates that he or she will perform substantially all of the services personally; and (3) the distributor does not have a substantial investment in facilities used in the performance of services, excluding facilities used for transportation. This provision also applies to distributors of meat, vegetable, fruit, and beverage (other than milk) products, as well as to distributors of laundry and dry cleaning services.

Description of Proposal

The proposal would delete distributors of bakery products from the list of product and service distributors treated as statutory employees for Social Security payroll tax purposes. Thus, the status of such workers would be determined under the generally applicable rules.

Effective Date

The proposal would be effective for services performed after December 31, 1997.

2. Clarification of standard to be used in determining tax status of retail securities brokers

Present Law

Under present law, whether a worker is an employee or independent contractor is generally determined under a common-law facts and circumstances test. An employer-employee relationship is generally found to exist if the service recipient has not only the right to control the result to be accomplished by the work, but also the means by which the result is to be accomplished. The Internal Revenue Service ("IRS") generally takes the position that the presence and extent of instructions is important in reaching a conclusion as to whether a business retains the right to direct and control the methods by which a worker performs a job, but that it is also important to consider the weight to be given those instructions if they are imposed by the business only in compliance with governmental or governing body regulations. The IRS training

manual provides that if a business requires its workers to comply with rules established by a third party (e.g., municipal building codes related to construction), the fact that such rules are imposed should be given little weight in determining the worker's status.

Description of Proposal

Under the proposal, in determining the status of a retail securities broker for Federal tax purposes, no weight would be given to instructions from the service recipient which are imposed only in compliance with governmental investor protection standards or investor protection standards imposed by a governing body pursuant to a delegation by a Federal or State agency.

Effective Date

The proposal would be effective with respect to services performed after December 31, 1997. No inference would be intended that the treatment under the proposal is not present law.

3. Clarification of exemption from self-employment tax for certain termination payments received by former insurance salesmen

Present Law

As part of the Federal Insurance Contributions Act ("FICA") a tax is imposed on employees and employers. The tax consists of two parts: old-age, survivor, and disability insurance ("OASDI") and Medicare Hospital Insurance ("HI"). For wages paid in 1997, the OASDI tax rate is 6.2 percent of wages up to \$65,400 (indexed for inflation) on both the employer and employee. The HI tax rate on both the employer and the employee is 1.45 percent of wages (with no wage cap).

Similarly, under the self-employment contributions act ("SECA"), taxes are imposed on an individual's net earnings from self employment. In general, net earnings from self employment means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed which are attributable to such trade or business. The SECA tax rate is the same as the combined employer and employee FICA rates (i.e., 12.4 percent for OASDI and 2.9 percent for HI) and the maximum amount of earnings subject to the OASDI portion of SECA taxes is coordinated with and is set at the same level as the maximum level of wages and salaries subject to the OASDI portion of FICA taxes. There is no limit on the amount of self-employment income subject to the HI portion of the tax.

Certain insurance salesmen are independent contractors and therefore subject to tax under SECA.

Under case law, certain payments received by a former insurance salesmen who had sold insurance as an independent contractor are not net earnings from self employment and therefore

are not subject to SECA. See, e.g., Jackson v. Comm'r, 108 TC __ No. 10 (1997); Gump v. U.S., 86 F. 3d 1126 (CA FC 1996); Milligan v. Comm'r, 38 F. 3d 1094 (9th Cir. 1994).

Description of Proposal

The proposal would codify case law by providing that net earnings from self employment would not include any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesman for such company if (1) such amount is received after termination of the individual's agreement to perform services for the company, (2) the individual performs no services for the company after such termination and before the close of the taxable year, (3) the amount of the payment depends solely on policies sold by the individual during the last year of the agreement and the extent to which such policies remain in force for some period after such termination, and does not depend on the length of service or overall earnings from services performed for the company, and (4) the payments are conditioned upon the salesman agreeing not to compete with the company for at least one year following such termination.

The proposal would also amend the Social Security Act to provide that such termination payments are not treated as earnings for purposes of determining social security benefits.

Effective Date

The proposal would be effective with respect to payments after December 31, 1997. No inference would be intended that the proposal is not present law.

4. Safe harbor for independent contractors

Present Law

Under present law, whether a worker is an employee or independent contractor is generally determined under a common-law facts and circumstances test. An employer-employee relationship is generally found to exist if the service recipient has not only the right to control the result to be accomplished by the work, but also the means by which the result is to be accomplished. Under a special safe harbor rule (section 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though the worker is in fact an employee if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. Section 530 does not apply to the worker and does not apply for income tax purposes. Section 530 does not apply to technical services personnel.

Description of Proposal

In general

The proposal would provide a statutory safe harbor for determining worker classification for Federal tax purposes. If the standards set forth in the proposal are met, the worker would not be treated as an employee and the service recipient (or payor) would not be treated as an employer. If the safe harbor is not satisfied, the determination of the worker's status would be made under the present-law rules.

Standards for determining whether individuals are not employees

Under the proposal, the following three sets of requirements would have to be satisfied in order for a worker not to be treated as an employee: (1) worker requirements regarding the service recipient; (2) worker requirements regarding others; and (3) documentation requirements. The requirements regarding the worker would be satisfied if, in connection with performing the services, the worker: (1) has a significant investment in assets and/or training; (2) incurs significant unreimbursed expenses; (3) agrees to perform the services for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause; (4) is paid primarily on a commissioned basis; or (5) purchases products for resale.

The requirements regarding others would be satisfied if one of the following two requirements is met: (1) a place of business requirement; or (2) a services available to the public requirement. The place of business requirement would be satisfied if the worker: (1) has a principal place of business; (2) does not primarily perform services in the service recipient's place of business; or (3) pays a fair market rent for use of the service recipient's place of business. The services available to the public requirement would be satisfied if the worker is not required to perform services exclusively for the service recipient, and during the year (or the preceding or subsequent year) the worker (1) has performed a significant amount of services for other persons; (2) has offered to perform services for other persons through advertising, individual written or oral solicitations, listings with agencies, brokers, or other organizations that provide referrals, or other similar activities; or (3) provides service under a business name that is registered with (or licensed by) a State or a political subdivision (or an agency or instrumentality of a State or political subdivision).

The documentation requirements would be satisfied if the services performed by the worker are performed pursuant to a written contract between the worker and the service recipient (or payor) and the contract provides that the worker will not be treated as an employee.

If the service recipient (or payor) fails to file the appropriate Federal tax returns (including information returns) with respect to a worker for a taxable year, the safe harbor would not be available for such year. Thus, the classification of the worker for the year would be determined under the present-law rules.

If the worker performs services through an entity owned in whole or in part by the worker, then the standards under the proposal could be applied to include the entity as the worker. The term service recipient (and payor) would not include any entity which is owned in whole or in part by the worker. Thus, the new standards would not apply to the relationship between the worker and an entity if the worker has any ownership interest in the service recipient (or payor) (e.g., if the worker provides services through a personal service corporation, the proposal would not apply with respect to the relationship between the worker and the personal service corporation).

Effective Date

The proposal would be effective with respect to services performed after December 31, 1997.

D. Provisions Relating to Small Business

1. Delay imposition of penalties for failure to make payments electronically through EFTPS until after December 31, 1998

Present Law

Employers are required to withhold income taxes and FICA taxes from wages paid to their employees. Employers also are liable for their portion of FICA taxes, excise taxes, and estimated payments of their corporate income tax liability.

The Code requires the development and implementation of an electronic fund transfer system to remit these taxes and convey deposit information directly to the Treasury (Code sec. 6302(h)⁵⁴). The Electronic Federal Tax Payment System ("EFTPS") was developed by Treasury in response to this requirement.⁵⁵ Employers must enroll with one of two private contractors hired by the Treasury. After enrollment, employers generally initiate deposits either by telephone or by computer.

The new system is phased in over a period of years by increasing each year the percentage of total taxes subject to the new EFTPS system. For fiscal year 1994, 3 percent of the total taxes are required to be made by electronic fund transfer. These percentages increased gradually for fiscal years 1995 and 1996. For fiscal year 1996, the percentage was 20.1 percent (30 percent for excise taxes and corporate estimated tax payments). For fiscal year 1997, these percentages increased significantly, to 58.3 percent (60 percent for excise taxes and corporate estimated tax payments). The specific implementation method required to achieve the target percentages is set forth in Treasury regulations. Implementation began with the largest depositors.

Treasury had originally implemented the 1997 percentages by requiring that all employers who deposit more than \$50,000 in 1995 must begin using EFTPS by January 1, 1997. The Small Business Job Protection Act of 1996 provided that the increase in the required percentages for fiscal year 1997 (which, pursuant to Treasury regulations, was to take effect on January 1, 1997) will not take effect until July 1, 1997.⁵⁶ This was done to provide additional time prior to implementation of the 1997 requirements so that employers could be better informed about their responsibilities.

⁵⁴ This requirement was enacted in 1993 (sec. 523 of P.L. 103-182).

⁵⁵ Treasury had earlier developed TAXLINK as the prototype for EFTPS. TAXLINK has been operational for several years; EFTPS is currently operational. Employers currently using TAXLINK will ultimately be required to participate in EFTPS.

⁵⁶ Sec. 1809 of P.L. 104-188.

On June 2, 1997, the IRS announced⁵⁷ that it will not impose penalties through December 31, 1997, on businesses that make timely deposits using paper federal tax deposit coupons while converting to the EFTPS system.

Description of Proposal

The proposal would provide that no penalty shall be imposed solely by reason of a failure to use EFTPS during the period from July 1, 1997 through December 31, 1998, if the taxpayer was first required to use the EFTPS system on or after July 1, 1997.

Effective Date

The provision would be effective on July 1, 1997.

2. Home office deduction: clarification of definition of principal place of business

Present Law

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent or depreciation and repairs). Code section 280A(c)(1) provides, however, that business deductions generally are allowed only with respect to a portion of a home that is used exclusively and regularly in one of the following ways: (1) as the principal place of business for a trade or business; (2) as a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit. In the case of an employee, the Code further requires that the business use of the home must be for the convenience of the employer (sec. 280A(c)(1)).⁵⁸ These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home (sec. 280A(f)(1)). Under Internal Revenue Service (IRS) rulings, the deductibility of expenses incurred for local transportation between a taxpayer's home and a work location sometimes depends on whether the taxpayer's home office qualifies under section 280A(c)(1) as a principal place of business (see Rev. Rul. 94-47, 1994-29 I.R.B. 6).

Prior to 1976, expenses attributable to the business use of a residence were deductible whenever they were "appropriate and helpful" to the taxpayer's business. In 1976, Congress

⁵⁷ IR-97-32.

⁵⁸ If an employer provides access to suitable space on the employer's premises for the conduct by an employee of particular duties, then, if the employee opts to conduct such duties at home as a matter of personal preference, the employee's use of the home office is not "for the convenience of the employer." See, e.g., W. Michael Mathes, (1990) T.C. Memo 1990-483.

adopted section 280A, in order to provide a narrower scope for the home office deduction, but did not define the term "principal place of business." In Commissioner v. Soliman, 113 S.Ct. 701 (1993), the Supreme Court reversed lower court rulings and upheld an IRS interpretation of section 280A that disallowed a home office deduction for a self-employed anesthesiologist who practiced at several hospitals but was not provided office space at the hospitals. Although the anesthesiologist used a room in his home exclusively to perform administrative and management activities for his profession (i.e., he spent two or three hours a day in his home office on bookkeeping, correspondence, reading medical journals, and communicating with surgeons, patients, and insurance companies), the Supreme Court upheld the IRS position that the "principal place of business" for the taxpayer was not the home office, because the taxpayer performed the "essence of the professional service" at the hospitals.⁵⁹ Because the taxpayer did not meet with patients at his home office and the room was not a separate structure, a deduction was not available under the second or third exception under section 280A(c)(1) (described above).

Section 280A(c)(2) contains a special rule that allows a home office deduction for business expenses related to a space within a home that is used on a regular (even if not exclusive) basis as a storage unit for the inventory or product samples of the taxpayer's trade or business of selling products at retail or wholesale, but only if the home is the sole fixed location of such trade or business.

Home office deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years (sec. 280A(c)(5)).

Description of Proposal

Section 280A would be amended to specifically provide that a home office qualifies as the "principal place of business" if (1) the office is used by the taxpayer to conduct administrative or management activities of a trade or business and (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business. As under present law, deductions would be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis as a place of business by the taxpayer, and in the case of an employee, only if such exclusive use is for the convenience of the employer.

⁵⁹ In response to the Supreme Court's decision in Soliman, the IRS revised its Publication 587, Business Use of Your Home, to more closely follow the comparative analysis used in Soliman by focusing on the following two primary factors in determining whether a home office is a taxpayer's principal place of business: (1) the relative importance of the activities performed at each business location; and (2) the amount of time spent at each location.

Thus, under the proposal, a home office deduction would be allowed (subject to the present-law "convenience of the employer" rule governing employees) if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer, who does not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (e.g., billing activities) are performed by others at other locations. The fact that a taxpayer also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, would not affect the taxpayer's ability to claim a home office deduction under the proposal. Moreover, if a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still would be eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial (e.g., the taxpayer occasionally does minimal paperwork at another fixed location of the business). In addition, a taxpayer's eligibility to claim a home office deduction under the proposal would not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home (e.g., meeting with, or providing services to, customers, clients, or patients at a fixed location of the business away from home).

If a taxpayer in fact does not perform substantial administrative or management activities at any fixed location of the business away from home, then the second prong of the proposal would be satisfied, regardless of whether or not the taxpayer opted not to use an office away from home that was available for the conduct of such activities. However, in the case of an employee, the question whether an employee chose not to use suitable space made available by the employer for administrative activities would be relevant to determining whether the present-law "convenience of the employer" test is satisfied. In cases where a taxpayer's use of a home office does not satisfy the proposal's two-part test, the taxpayer nonetheless may be able to claim a home office deduction under the present-law "principal place of business" exception or any other provision of section 280A.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1997.

E. Provisions Relating to Pensions and Other Benefits

1. Cash or deferred arrangements for irrigation and drainage entities

Present Law

Under present law, taxable and tax-exempt employers may maintain qualified cash or deferred arrangements. State and local government organizations generally are prohibited from establishing qualified cash or deferred arrangements ("section 401(k) plans"). This prohibition does not apply to qualified cash or deferred arrangements adopted by a State or local government before May 6, 1986.

Mutual irrigation or ditch companies are exempt from tax if at least 85 percent of the income of the company consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Description of Proposal

Under the proposal, a mutual irrigation or ditch company or a district organized under the laws of a State as a municipal corporation for the purpose of irrigation, water conservation or drainage (or a national association of such organizations) would be permitted to maintain qualified cash or deferred arrangements, even if such company or district is a State or local government organization.

Effective Date

The provision would be effective with respect to years beginning after December 31, 1997.

2. Portability of permissive service credit under governmental pension plans

Present Law

Under present law, limits are imposed on the contributions and benefits under qualified pension plans. Certain special rules apply in the case of State and local governmental plans.

In the case of a defined contribution plan, the limit on annual additions is the lesser of \$30,000 or 25 percent of compensation. Annual additions include employer contributions, as well as after-tax employee contributions. In the case of a defined benefit pension plan, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) \$120,000 (indexed for inflation). The 100 percent of compensation limitation does not apply in the case of State and local governmental pension plans.

Amounts contributed by employees to a State or local governmental plan are treated as made by the employer if the employer "picks up" the contribution.

Description of Proposal

Under the proposal, in applying the defined benefit pension plan limit, the annual benefit under a State or local governmental plan would include the accrued benefit derived from contributions to purchase permissive service credit. Such contributions would not be taken into account in determining annual additions.

Permissive service credit would mean credit for a period of service recognized by the governmental plan if the employee contributes to the plan an amount (as determined by the plan) which does not exceed the amount necessary to fund the accrued benefit attributable to such period of service.

The proposal would not affect the treatment of "pick up" contributions.

Effective Date

The proposal would be effective with respect to years beginning after December 31, 1997.

3. Extend moratorium on nondiscrimination rules for governmental plans

Present Law

Under present law, the rules applicable to governmental plans require that such plans satisfy certain nondiscrimination rules. In general, the rules require that a plan not discriminate in favor of highly compensated employees with regard to the contribution and benefits provided under the plan, participation in the plan, coverage under the plan, and compensation taken into account under the plan. The nondiscrimination apply to all governmental plans; qualified retirement plans (including cash or deferred arrangements (sec. 401(k) plans) in effect before May 6, 1986) and annuity plans (sec. 403(b) plans).

For purposes of satisfying the nondiscrimination rules, the Internal Revenue Service has extended the effective date for compliance for governmental plans (Notice 92-36). Governmental plans will be required to comply with the nondiscrimination rules beginning with plan years beginning on or after the later of January 1, 1999, or 90 days after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously. For plan years beginning before the extended effective date, governmental plans are deemed to satisfy the nondiscrimination requirements.

Description of Proposal

The proposal would provide that the relief provided by IRS Notice 92-36 would extend at least through plan years beginning before January 1, 2003. The IRS could extend the date further.

Effective Date

The proposal would be effective on the date of enactment.

4. Treatment of certain disability payments to public safety employees

Present Law

Under present law, amounts received under a workmen's compensation act as compensation for personal injuries or sickness incurred in the course of employment are excluded from gross income. Compensation received under a workmen's compensation act by the survivors of a deceased employee also are excluded from gross income. Non-occupational death and disability benefits are not excludable from income as workmen's compensation benefits.

Description of Proposal

Under the proposal, certain payments made on behalf of full-time employees of any police or fire department organized and operated by a State (or any political subdivision, agency, or instrumentality thereof) would be excludable from income. The proposal would apply to payments made on account of heart disease or hypertension of the employee and that were received in 1989, 1990, 1991 pursuant to a State law as amended on May 19, 1992, which irrebuttably presumed that heart disease and hypertension are work-related illnesses, but only for employees separating from service before July 1, 1992.

The proposal would provide that claims for refund of or credit for overpayment of tax resulting from the proposal could be filed up to 1 year after the date of enactment, without regard to the otherwise applicable statute of limitations.

Effective Date

The proposal would be effective on the date of enactment.

F. Extension of Duty-Free Treatment Under Generalized System of Preferences

Present Law

Title V of the Trade Act of 1974, as amended (Generalized System of Preferences, "GSP"), grants authority to the President to provide duty-free treatment on imports of eligible articles from designated beneficiary developing countries, subject to specific conditions and limitations. To qualify for GSP privileges each beneficiary country is subject to various mandatory and discretionary eligibility criteria. Import sensitive products are ineligible for GSP. The President's authority to grant GSP benefits expired on May 31, 1997.

Description of Proposal

The proposal would reauthorize the GSP program for two years, to terminate on May 31, 1999. The proposal would provide for refunds, upon request of the importer, of any duty paid between May 31, 1997, and the date of enactment.

Effective Date

The proposal would be effective upon date of enactment.

G. United States-Caribbean Basin Trade Partnership Program

Present Law

The Caribbean Basin Initiative ("CBI"), is a program to further the economic development and political stability of countries in the Caribbean and Central America. The Caribbean Basin Economic Recovery Act ("CBERA") was enacted in 1983, and was made permanent in 1990. Under the CBERA, the President is authorized to grant, to countries in the Caribbean and Central America, duty-free access to the U.S. market under certain conditions. Products which are excluded from duty-free treatment under the CBERA include: textile and apparel articles, canned tuna, petroleum and petroleum products, footwear, handbags, luggage, flat goods, work gloves, leather-wearing apparel, and certain watches.

Description of Proposal

The proposal would amend 213(b) of the Caribbean Basin Economic Recovery Act to provide tariff and quota treatment on imports from CBI beneficiary countries of excluded articles that is identical to tariff and quota treatment accorded like articles imported from Mexico under the North American Free Trade Agreement ("NAFTA") during a temporary period of up to one year (January 1, 1998-December 31, 1998). The proposal provides the NAFTA tariff and quota treatment would apply to articles currently excluded from CBI duty-free treatment which meet NAFTA rules of origin (treating the United States and CBI beneficiary countries as "parties" under the agreement of this purpose). Imports of articles currently excluded under CBI, which do not meet the conditions of NAFTA parity, would continue to be excluded from the CBI program. A temporary transitional period would begin on January 1, 1998, and end on the date that either NAFTA accession or a reciprocal free trade agreement enters into force with the beneficiary country, or on December 31, 1998, whichever is earlier.

Imports of textile and apparel products meeting NAFTA rules of origin, or assembled in the Caribbean from fabric wholly cut and formed in the United States, would enter duty-free and quota-free. There would be no change in the treatment of non-originating textile products currently subject to import quotas under bilateral and multilateral textile agreements. The proposal authorizes the USTR to establish tariff preferential levels ("TPLs") (tariff-rate quotas with preferential duties) during the transition period in Caribbean Basin textile products similar to those established for Mexico in the NAFTA for non-originating articles, after consulting with the domestic industry and other interested parties.

The proposal would require the President to conduct and report to Congress on benefits accorded under the proposal based on eligibility criteria in current law as further interpreted by the proposal. These criteria include intellectual property protection, investment protection, market access, worker rights, cooperation in administering the program, and the degree to which the country follows accepted rules of international trade provided for under the World Trade Organization. The President may determine, based on the review, whether to withdraw, suspend,

or limit new benefits. Existing authority would continue to withdraw, suspend, or limit current benefits as any time based on present criteria.

Effective Date

The proposal would be effective for the period January 1, 1998 through December 31, 1998.

H. Other Provisions

1. Shrinkage for inventory accounting

Present Law

Section 471(a) provides that "(w)henever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income." Where a taxpayer maintains book inventories in accordance with a sound accounting system, the net value of the inventory will be deemed to be the cost basis of the inventory, provided that such book inventories are verified by physical inventories at reasonable intervals and adjusted to conform therewith. (Treas. reg. sec. 1.471-2(d)). The physical count is used to determine and adjust for certain items, such as undetected theft, breakage, and bookkeeping errors, collectively referred to as shrinkage.

Many taxpayers verify and adjust their book inventories by a physical count taken on the last day of the taxable year. Other taxpayers may verify and adjust their inventories by physical counts taken at other times during the year. Still other taxpayers take physical counts at different locations at different times during the taxable year (cycle counting).

Description of Proposal

The proposal would provide that a method of keeping inventories will not be considered unsound, or to fail to clearly reflect income, solely because it includes an adjustment for the shrinkage estimated to occur through year-end, based on inventories taken other than at year-end. Such an estimate must be based on actual physical counts. Where such an estimate is used in determining ending inventory balances, the taxpayer would be required to take a physical count of inventories at each location on a regular and consistent basis. A taxpayer would be required to adjust its ending inventory to take into account all physical counts performed through the end of its taxable year.

A taxpayer would be permitted to change its method of accounting for inventories to include shrinkage estimates based on physical inventories taken other than at year-end. Such change would be treated as a voluntary change in method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury, provided the taxpayer changes to a permissible method of accounting. The period for taking into account any adjustment required under section 481 as a result of such a change in method would be 4 years.

Effective Date

The proposal would be effective for taxable years ending after the date of enactment. No inference is intended with regard to the validity of any method of keeping inventories under present law.

2. Treatment of workmen's compensation liability under rules for certain personal injury liability assignments

Present Law

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

Description of Proposal

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

Effective Date

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

3. Treatment of certain publicly traded partnerships

A publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704). An exception to the rule treating the partnership as a corporation applies if 90 percent of the partnership's gross income consists of "passive-type income," which includes (1) interest (other than interest derived in a financial or insurance business, or certain amounts determined on the basis of income or profits), (2) dividends, (3) real property rents (as defined for purposes of the provision), (4) gain from the sale or other disposition of real property, (5) income and gains relating to minerals and natural resources (as defined for purposes of the provision), and (6) gain from the sale or disposition of a capital asset (or certain trade or business property) held for the production of income of the foregoing types (subject to an exception for certain commodities income).

The exception for publicly traded partnerships with "passive-type income" does not apply to any partnership that would be described in section 851(a) of the Code (relating to regulated investment companies, or "RICs"), if that partnership were a domestic corporation. Thus, a publicly traded partnership that is registered under the Investment Company Act of 1940 generally is treated as a corporation under the provision. Nevertheless, if a principal activity of the partnership consists of buying and selling of commodities (other than inventory or property held primarily for sale to customers) or futures, forwards and options with respect to commodities, and 90 percent of the partnership's income is such income, then the partnership is not treated as a corporation.

A publicly traded partnership is a partnership whose interests are (1) traded on an established securities market, or (2) readily tradable on a secondary market (or the substantial equivalent thereof).

Treasury regulations provide detailed guidance as to when an interest is treated as readily tradable on a secondary market or the substantial equivalent. Generally, an interest is so treated "if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market" (Treas. Reg. sec. 1.7704-1(c)(1)).

When the publicly traded partnership rules were enacted in 1987, a 10-year grandfather rule provided that the provisions apply to certain existing partnerships only for taxable years beginning after December 31, 1997.⁶⁰ An existing publicly traded partnership is any partnership, if (1) it was a publicly traded partnership on December 17, 1997, (2) a registration statement indicating that the partnership was to be a publicly traded partnership was filed with the Securities and Exchange Commission with respect to the partnership on or before December 17, 1987, or (3) with respect to the partnership, an application was filed with a State regulatory commission on or before December 31, 1987, seeking permission to restructure a portion of a

⁶⁰ Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203), sec. 10211(c).

corporation as a publicly traded partnership. A partnership that otherwise would be treated as an existing publicly traded partnership ceases to be so treated as of the first day after December 17, 1987, on which there has been an addition of a substantial new line of business with respect to such partnership. A rule is provided to coordinate this grandfather rule with the exception to the rule treating the partnership as a corporation applies if 90 percent of the partnership's gross income consists of passive-type income. The coordination rule provides that passive-type income exception applies only after the grandfather rule ceases to apply (whether by passage of time or because the partnership ceases to qualify for the grandfather rule).

Description of Proposal

In the case of an existing publicly traded partnership that elects under the proposal to be subject to a tax on gross income from the active conduct of a trade or business, the rule of present law treating a publicly traded partnership as a corporation would not apply. An existing publicly traded partnership would be any publicly traded partnership that is not treated as a corporation, so long as such treatment is not determined under the passive-type income exception of Code section 7704(c)(1). The election to be subject to the tax on gross trade or business income, once made, would remain in effect until revoked by the partnership, and could not be reinstated.

The tax would be 15 percent of the partnership's gross income from the active conduct of a trade or business. The partnership's gross trade or business income would include its share of gross trade or business income of any lower-tier partnership. The tax imposed under the proposal could not be offset by tax credits.

Effective Date

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

4. Exclusion from UBIT for certain corporate sponsorship payments

Present Law

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511-514). Contributions or gifts received by tax-exempt organizations generally are not subject to the UBIT. However, present-law section 513(c) provides that an activity (such as advertising) does not lose its identity as a separate trade or business merely because it is carried on within a larger complex of other endeavors.⁶¹ If a

⁶¹ See United States v. American College of Physicians, 475 U.S. 834 (1986)(holding that activity of selling advertising in medical journal was not substantially related to the

tax-exempt organization receives sponsorship payments in connection with an event or other activity, the solicitation and receipt of such sponsorship payments may be treated as a separate activity. The Internal Revenue Service (IRS) has taken the position that, under some circumstances, such sponsorship payments are subject to the UBIT.⁶²

Description of Proposal

Under the proposal, qualified sponsorship payments received by a tax-exempt organization (or State college or university described in section 511(a)(2)(B)) would be exempt from the UBIT.

"Qualified sponsorship payments" would be defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the organization's activities.⁶³ Such a use or acknowledgment would not include advertising of such person's products or services -- meaning qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services. Thus, for example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event conducted by the organization, such payment would not be subject to the UBIT. In contrast, if the organization provides advertising of a sponsor's products, the payment made to the organization by the sponsor in order to receive such advertising would be subject to the UBIT (provided that the other, present-law requirements for UBIT liability are satisfied).

The proposal would specifically provide that a qualified sponsorship payment would not include any payment where the amount of such payment is contingent, by contract or otherwise, upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree

organization's exempt purposes and, as a separate business under section 513(c), was subject to tax).

⁶² See Prop. Treas. Reg. sec. 1.513-4 (issued January 19, 1993, EE-74-92, IRB 1993-7, 71). These proposed regulations generally exclude from the UBIT financial arrangements under which the tax-exempt organization provides so-called "institutional" or "good will" advertising to a sponsor (i.e., arrangements under which a sponsor's name, logo, or product line is acknowledged by the tax-exempt organization). However, specific product advertising (e.g., "comparative or qualitative descriptions of the sponsor's products") provided by a tax-exempt organization on behalf of a sponsor is not shielded from the UBIT under the proposed regulations.

⁶³ In determining whether a payment is a qualified sponsorship payment, it would be irrelevant whether the sponsored activity is related or unrelated to the organization's exempt purpose.

of public exposure to an activity. However, the fact that a sponsorship payment is contingent upon an event actually taking place or being broadcast, in and of itself, would not cause the payment to fail to be a qualified sponsorship payment. Moreover, mere distribution or display of a sponsor's products by the sponsor or the tax-exempt organization to the general public at a sponsored event, whether for free or for remuneration, would be considered to be "use or acknowledgment" of the sponsor's product lines (as opposed to advertising), and thus would not affect the determination of whether a payment made by the sponsor is a qualified sponsorship payment.

The proposal would not apply to the sale of advertising or acknowledgments in tax-exempt organization periodicals. For this purpose, the term "periodical" would mean regularly scheduled and printed material published by (or on behalf of) the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization. For example, the proposal would not apply to payments that lead to acknowledgments in a monthly journal, but would apply if a sponsor receives an acknowledgment in a program or brochure distributed at a sponsored event.

The proposal would specifically provide that, to the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of the payment would be treated as a separate payment. Thus, if a sponsorship payment made to a tax-exempt organization entitles the sponsor to both product advertising and use or acknowledgment of the sponsor's name or logo by the organization, then the UBIT would not apply to the amount of such payment that exceeds the fair market value of the product advertising provided to the sponsor. Moreover, the provision of facilities, services or other privileges by an exempt organization to a sponsor or the sponsor's designees (e.g., complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) in connection with a sponsorship payment would not affect the determination of whether the payment is a qualified sponsorship payment. Rather, the provision of such goods or services would be evaluated as a separate transaction in determining whether the organization has unrelated business taxable income from the event. In general, if such services or facilities do not constitute a substantial return benefit or if the provision of such services or facilities is a related business activity, then the payments attributable to such services or facilities would not be subject to the UBIT. Moreover, just as the provision of facilities, services or other privileges by a tax-exempt organization to a sponsor or the sponsor's designees (complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) would be treated as a separate transaction that does not affect the determination of whether a sponsorship payment is a qualified sponsorship payment, a sponsor's receipt of a license to use an intangible asset (e.g., trademark, logo, or designation) of the tax-exempt organization likewise would be treated as separate from the qualified sponsorship transaction in determining whether the organization has unrelated business taxable income.

The exemption provided by the proposal would be in addition to other present-law exceptions from the UBIT (e.g., the exceptions for activities substantially all the work for which is performed by volunteers and for activities not regularly carried on). No inference would be intended as to whether any sponsorship payment received prior to 1998 was subject to the UBIT.

Effective Date

The proposal would apply to qualified sponsorship payments solicited or received after December 31, 1997.

5. Timeshare associations

Present Law

Taxation of homeowners associations making the section 528 election.--Under present law (sec. 528), condominium management associations and residential real estate management associations may elect to be taxable at a 30 percent rate on their "homeowners association income" if they meet certain income, expenditure, and organizational requirements.

"Homeowners association income" is the excess of the association's gross income, excluding "exempt function income," over allowable deductions directly connected with non-exempt function gross income. "Exempt function income" includes membership dues, fees, and assessments for a common activity undertaken by association members or owners of residential units in the condominium or subdivision. Homeowners association income includes passive income (interest and dividends) earned on reserves and fees for use of association property (e.g., swimming pools, meeting rooms, etc.).

In order to qualify for this treatment, at least 60 percent of the association's gross income must consist of membership dues, fees, or assessments on owners, at least 90 percent of its expenditures must be for the acquisition, management, maintenance, or care of "association property," and no part of its net earnings can inure to the benefit of any private shareholder. "Association property" means (1) property held by the association, (2) property commonly held by association members, (3) property within the association privately held by association members, and (4) property held by a governmental unit for the benefit of association members. In addition to these statutory requirements, Treasury regulations require that the units of the association be used for residential purposes. Use is not a residential use if the unit is occupied by a person or series of persons less than 30 days for more than half of the association's taxable year. Treas. reg. sec. 1.528-4(d).

Taxation of homeowners associations not making the section 528 election.--Homeowners associations that do not (or cannot) make the section 528 election are taxed either as a tax-exempt social welfare organization under sec. 501(c)(4) or as a regular C corporation. In order for an organization to qualify as a tax-exempt social welfare organization, the organization must meet the following three requirements: (1) the association must serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit; (2) the association may not conduct activities directed to exterior maintenance of any private residence, and (3) common areas of association facilities must be for the use and enjoyment of the general public (Rev. Rul. 74-99, 1974-1 C.B. 131).

Non-exempt homeowners associations are taxed as C corporations, except that (1) the association may exclude excess assessments that it refunds to its members or applies to the subsequent year's assessments (Rev. Rul. 70-604, 1970-2 C.B. 9); (2) gross income does not include special assessments held in a special bank account (Rev. Rul. 75-370, 75-2 C.B. 25), and (3) assessments for capital improvements are treated as non-taxable contributions to capital (Rev. Rul. 75-370, 1975-2 C.B. 25).

Taxation of timeshare associations.--Under present law, timeshare associations are taxed as regular C corporations because (1) they cannot meet the requirement of the Treasury regulations for the section 528 election that the units be used for residential purposes (i.e., the 30-day rule) and they have relatively large amount of services performed for its owners (e.g., maid and janitorial services) and (2) they cannot meet any of requirements of Rev. Rul. 74-99 for tax-exempt status under section 501(c)(4). In addition, the IRS recently has challenged the exclusions from gross income as a C corporation of refunds of excess assessments, special assessments held in a segregated account, and capital assessments as contributions to capital. See P.L.R. 9539001 (June 8, 1995) and the taxpayer's protest.

Description of Proposal

The proposal would amend section 528 to permit timeshare associations to qualify for taxation under that section. Timeshare associations would have to meet the other requirements of section 528 (e.g., the 60 percent gross income, 90 percent expenditure, and the non-profit organization and operation basis requirements) and be subject to a 32 percent tax rate.

Effective Date

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

6. Modification of advance refunding rules for certain tax-exempt bonds issued by the Virgin Islands

Present Law

Advance refundings

Generally, a governmental bond originally issued after December 31, 1985, may be advance refunded one time. An advance refunding is any refunding where all of the refunded bonds are not redeemed within 90 days after the refunding bonds are issued.

Virgin Island bonds

Under present law, the Virgin Islands is required to secure its bonds with a priority first lien claim on specified revenue streams rather than being permitted to issue multiple bond issues

secured on a parity basis by a common pool of revenues. Under a proposed non-tax law change, the priority lien requirement would be repealed.

Description of Proposal

One additional advance refunding would be allowed for governmental bonds issued by the Virgin Islands that were advance refunded before June 9, 1997, if the Virgin Islands debt provisions are changed to repeal the current priority first lien requirement.

Effective Date

The proposal would be effective on the date of enactment.

7. Deduction for business meals while operating under Department of Transportation hours of service limitations

Present Law

Ordinary and necessary business expenses, as well as expenses incurred for the production of income are generally deductible, subject to a number of restrictions and limitations. The amount allowable as a deduction for food and beverage is limited to 50 percent of the otherwise deductible amount. Exceptions to this 50 percent rule are provided for food and beverages provided to crew members of certain vessels and offshore oil or gas platforms or drilling rigs.

Description of Proposal

The proposal would increase to 80 percent the deductible percentage of the cost of food and beverages consumed while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation. The increase in the deductible percentage would be phased in according to the following schedule:

<u>Taxable years beginning in</u>	<u>Deductible Percentage</u>
1998, 1999	55 percent
2000, 2001	60 percent
2002, 2003	65 percent
2004, 2005	70 percent
2006, 2007	75 percent
2008 and thereafter	80 percent

Effective Date

The proposal would be effective for taxable years beginning after 1997.

8. Treatment of State workmen's compensation funds

Present Law

In general, the Internal Revenue Service ("IRS") takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis.

Certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses); (2) serve an important common business interest of their members; and (3) must be membership organizations financed, at least in part, by membership dues.

State insurance risk pools may also qualify for tax exempt status under section 501(c)(4) as a social welfare organizations or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of "commercial-type insurance" contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof. However, the IRS may be reluctant to rule that particular State risk-pooling entities satisfy the section 501(c)(4) or 115 requirements for tax-exempt status.

Description of Proposal

The proposal would clarify the tax-exempt status of any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer. The organization must provide workmen's compensation to any employer in the State seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to debt of the organization or make a substantial capital investment in the organization. The assets of the organization must revert to the State upon dissolution of the organization. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997. No inference would be intended as to prior law.

9. Deferral of gain on certain sales of farm product refiners and processors

Present Law

Under present law, if certain requirements are satisfied, a taxpayer may defer recognition of gain on the sale of qualified securities to an employee stock ownership plan ("ESOP") to the extent that the taxpayer reinvests the proceeds in qualified replacement property (sec. 1042). Gain is recognized when the taxpayer disposes of the qualified replacement property. One of the requirements that must be satisfied for deferral to apply is that, immediately after the sale, the ESOP must own at least 30 percent of the stock of the corporation issuing the qualified securities. In general, qualified securities are securities issued by a domestic C corporation that has no stock outstanding that is readily tradeable on an established securities market. Deferral treatment does not apply to gain on the sale of qualified securities by a C corporation.

Description of Proposal

The proposal would extend the deferral provided under section 1042 to the sale of stock of a qualified refiner or processor to an eligible farmer's cooperative. A qualified refiner or processor would mean a domestic corporation substantially all of the activities of which consist of the active conduct of the trade or business of refining or processing agricultural or horticultural products and which purchases more than one-half of such products to be refined or processed from farmers who make up the cooperative which is purchasing the stock. An eligible farmers' cooperative would mean an organization which is treated as a cooperative for Federal income tax purposes and which is engaged in the marketing of agricultural or horticultural products.

The deferral of gain would only be available if, immediately after the sale, the eligible farmers' cooperative owns 100 percent of the qualified refiner or processor. The proposal would apply even if the stock of the qualified refiner or processor is publicly traded. In addition, the proposal would apply to gain on the sale of stock by a C corporation.

Effective Date

The proposal would apply to sales after December 31, 1997.

X. REVENUE-INCREASE PROVISIONS

A. Financial Products

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

Present Law

Timing of gain or loss

In general, gain or loss is taken into account for tax purposes when realized. Gain or loss generally is 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 (sec. 1233(b)).

Taxpayers also can lock in gain on certain property by entering into offsetting positions in the same or similar property. Under the straddle rules, when a taxpayer realizes a loss on one offsetting position in actively-traded personal property, the taxpayer generally can deduct this loss only to the extent the loss exceeds 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 the offsetting positions in a straddle (sec. 1092).

Taxpayers may engage in other arrangements, such as "futures contracts," "forward contracts," "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 gain and 60 percent long-term gain (sec. 1256).

Securities dealers

A dealer in securities must compute its income pursuant to a mark-to-market method of accounting (section 475). Any security that is inventory must be included in inventory at its fair market value, and any security that is not inventory and that is held at year end is treated as sold for its fair market value. There is an exception to mark-to-market treatment for any security identified as held for investment or not held for sale to customers (or a hedge of such a security). For this purpose, a "dealer in securities" is a person who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For this purpose, "security" means any stock in a corporation; any partnership or beneficial ownership interest in a widely-held or publicly-traded partnership or trust; any note, bond, debenture, or other evidence of indebtedness; an interest rate, currency or equity notional principal contract; any evidence of an interest in, or a derivative financial instrument of any security described above; and certain positions identified as hedges of any of the above. Any gain or loss taken into account under these provisions generally is treated as ordinary gain or loss.

Traders in securities generally are taxpayers who engage in a trade or business involving active sales or exchanges of securities on the market, rather than to customers. The mark-to-market treatment applicable to securities dealers does not apply to traders in securities or to dealers in other property.

Investment companies

A contribution of property to a corporation does not result in gain or loss to the contributing shareholder if the contributor is part of a group of contributors who own 80 percent of the voting stock of each class of stock entitled to vote. A contribution of property to a partnership generally does not result in recognition of gain or loss to the contributing partner.

Certain Code sections provide exceptions to the general rule for deferral of pre-contribution gain and loss. Gain and loss is recognized upon a contribution by a shareholder to a corporation that is an investment company (section 351(e)(1)). Gain, but not loss, is recognized upon a contribution by a partner to a partnership that would be treated as an investment company if

the partnership were a corporation (section 721(b)). Under Treasury regulations, a contribution of property by a shareholder to a corporation, or by a partner to a partnership, is treated as a transfer to an investment company only if (1) the contribution results, directly or indirectly, in a diversification of the transferor's interests, and (2) the transferee is (a) a regulated investment company ("RIC"), (b) a real estate investment trust ("REIT"), or (c) a corporation more than 80 percent of the assets of which by value (excluding cash and non-convertible debt instruments) are readily marketable stocks or securities or interests in RICs or REITs that are held for investment (Treas. reg. sec. 1.351-1(c)(1)).

Description of Proposal

The proposal contains provisions that would treat certain transactions involving appreciated financial positions as constructive sales, that would allow securities traders and commodities traders and dealers to elect mark-to-market accounting, and that would expand the definition of an investment company.

Constructive sales

The proposal would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest or certain debt instruments. 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) does one of the following: (1) enters into a short sale of the same property, (2) enters into an offsetting notional principal contract with respect to the same property, or (3) enters into a futures or forward contract to deliver the same property. In addition, for a taxpayer that has entered into a short sale, a notional principal contract or a futures or forward contract, the taxpayer would be treated as making a constructive sale when he acquires property that is the same as the underlying property for the position. Finally, to the extent provided in Treasury regulations, a taxpayer would be treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described. A constructive sale under any part of the definition would occur if the two positions were in property that, although not the same, was substantially identical.

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 in the basis of the appreciated financial position would be made in the amount of any gain realized under the proposal, 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 if the position were sold. Certain actively-traded trust instruments would be treated as stock for this purpose. The proposal provides an exception for debt instruments the interest on which is not contingent on profits, the borrower's

discretion or similar factors and which are not convertible, directly or indirectly, into stock. A position is defined as any interest, including a futures or forward contract, short sale, or option.

A constructive sale would not include a transaction involving an appreciated financial position that is marked to market, including positions governed by section 475 (mark to market for securities dealers) or section 1256 (mark to market for futures contracts, options and currency contracts).

The proposal would provide an exception from constructive sale treatment for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into. This exception would not apply, however, where a transaction is closed during the last 60 days of the taxable year or within 30 days thereafter unless (1) the taxpayer holds the appreciated financial position to which the transaction relates (e.g. the stock where the transaction is a short sale) throughout the 60-day period beginning on the date the transaction is closed and (2) at no time during such 60-day period is the taxpayer's risk of loss reduced by holding positions with respect to substantially similar or related property.

A person would be considered related to another for purposes of the proposal if the relationship was one described in section 267 or section 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 any type of property held by the taxpayer, the specific property deemed sold would be determined under the rules governing actual sales, after adjusting for previous constructive sales under the proposal.

Extension of mark-to-market treatment by election

The proposal would allow securities traders and commodities traders and dealers to elect application of the mark-to-market accounting rules, which apply only to securities dealers under present law. Securities held by an electing taxpayer in connection with a trade or business as a securities trader or a commodities trader or dealer would be treated as not held for investment under section 475, and thus would generally be subject to mark-to-market treatment. The election would be made separately with respect to each trade or business of the taxpayer, such as a business as a securities trader or a business as a commodities dealer. The election would be effective for the taxable year for which it is made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury. As under present law, gain or loss recognized by an electing taxpayer under the proposal would be ordinary gain or loss, and the taxpayer would be allowed to identify property not held in connection with its trade or business as not subject to the election.

Investment company definition

The proposal would expand the definition of an investment company for purposes of determining whether a transfer of property to a partnership or corporation results in gain

recognition. An investment company would include a RIC or REIT as under present law. In addition, under the proposal, an investment company would include any corporation or partnership if more than 80 percent of its assets by value (other than assets held in a dealer capacity) consist of money, financial instruments, foreign currency, interests in REITs, RICs, common trust funds and publicly-traded partnerships, and certain interests in precious metals and entities that hold the above-listed items. In addition, the Treasury would be granted regulatory authority to add other items to this list.

Effective Date

The proposal would be effective for constructive sales entered into after June 8, 1997. A special rule is provided for transactions before this date which would have been constructive sales under the proposal. The positions in such a transaction would not be taken into account in determining whether a constructive sale after June 8, 1997, has occurred, provided that the taxpayer identifies the offsetting positions of the earlier transaction within 30 days after the date of enactment. The special rule would cease to apply to on the date the taxpayer ceases to hold any of the positions so identified.

In the case of a decedent dying after June 8, 1997, if (1) a constructive sale of an appreciated financial position (as defined in the proposal) occurred before such date, (2) the transaction remains open for not less than two years, and (3) the transaction is not closed in a taxable transaction within 30 days after the date of enactment, 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.

The mark-to-market accounting election would apply to taxable years of securities traders beginning after the date of enactment. For a taxpayer making this election, the adjustments required under section 481 as a result of the change in accounting method are required to be taken into account ratably over a four-year period.

The change in the definition of an investment company would apply to all transfers after June 8, 1997, in taxable years ending after such date. An exception would be provided for transfers pursuant to a binding written contract in effect on June 9, 1997, and at all times thereafter until the transfer.

2. 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.⁶⁴

Application to non-financial corporations

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

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

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

Interest on installment sales to State and local governments.--If a taxpayer sells property to a State or local government in exchange for an installment obligation, interest on the obligation may be exempt from tax. Present law has been interpreted to not disallow interest on a taxpayer's indebtedness if the taxpayer acquires nonsalable tax-exempt obligations in the ordinary course of business in payment for services performed for, or goods supplied to, State or local governments.⁶⁵

⁶⁴ Code section 7701(f) (as enacted in the Deficit Reduction Act of 1984 (sec. 53(c) of P.L. 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.

⁶⁵ R.B. George Machinery Co., 26 B.T.A. 594 (1932) acq. C.B. XI-2, 4; Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669.

Application to financial corporations and dealers in tax-exempt obligations

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)). A similar pro rata rule applies to dealers in tax-exempt obligations, but there is no small issuer exception, and the 20-percent disallowance rule does not apply (Rev. Proc. 72-18).

Treatment of insurance companies

Present law provides that a life insurance company's deduction for additions to reserves is reduced by a portion of the company's income that is not subject to tax (generally, tax-exempt interest and deductible intercorporate dividends) (secs. 807 and 812). The portion by which the life insurance company's reserve deduction is reduced is related to its earnings rate. Similarly, in the case of property and casualty insurance companies, the deduction for losses incurred is reduced by a percentage (15 percent) of (1) the insurer's tax-exempt interest and (2) the deductible portion of dividends received (with special rules for dividends from affiliates) (sec. 832(b)(5)(B)). If the amount of this reduction exceeds the amount otherwise deductible as losses incurred, the excess is includible in the property and casualty insurer's income.

Description of Proposal

The proposal would extend to all corporations (other than insurance companies) 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. In addition, there would be a de minimis exception under which the disallowance rule would not apply to corporations, other than financial institutions and dealers in tax-exempt obligations, if the average adjusted basis of tax exempt obligations acquired after August 7, 1986, is less than the lesser of \$1 million or 2 percent of the basis of all of the corporation's assets. Under the proposal, insurance companies would not be subject to the pro rata rule and would be subject to present law. Finally, the proposal would apply the interest disallowance provision to all related persons (within the meaning of section 267(f)⁶⁶).

⁶⁶ Under sec.267 (f), a corporation and its 50-percent subsidiaries are treated as one beneficiary, as are "brother-sister" corporations that are 50 percent (by vote or value) controlled

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 company. 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 the date of enactment with respect to obligations acquired after June 8, 1997.

3. 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.⁶⁷ 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). 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"⁶⁸ 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

by 5 or fewer persons who also own more than 50 percent (by vote or value) of each corporation, counting only stock ownership of each person to the extent it is identical in each corporation. (sec. 1563(a)).

⁶⁷ See Fairbanks v. U.S., 306 U.S. 436 (1939); Comm'r v. Pittston Co., 252 F. 2d 344 (2d Cir.), cert. denied, 357 U.S. 919 (1958).

⁶⁸ A "section 1256 contract" means (1) any regulated futures contract, (2) foreign currency contract, (3) nonequity option, or (4) dealer equity option.

addition, gain on the sale or exchange of a debt instrument with OID⁶⁹ 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 property acquired or positions established 30 day after the date of enactment of the proposal.

Character of gain on retirement of debt obligations issued by natural persons.--The repeal of the exception to the character of gain on retirement of debt instruments issued by natural persons or obligations issued before July 2, 1982, would apply to purchases and debt issued 30 days after date of enactment of the proposal.

⁶⁹ 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)).

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

Present Law

Inclusion of interest income, in general

A taxpayer generally must include in gross income the amount of interest received or accrued within the taxable year on indebtedness held by the taxpayer. If the principal amount of an indebtedness may be paid without interest by a specified date (as is the case with certain credit card balances), under present law, the holder of the indebtedness is not required to accrue interest until after the specified date has passed.

Original issue discount

The holder of a debt instrument with original issue discount ("OID") generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the amount of the interest may not be received 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. Issuers of OID instruments accrue and deduct the amount of OID as interest expense in the same manner as the holder.

Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. First, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt. In addition, 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. Thus, under the proposal, if a taxpayer holds a pool of credit card receivables that require interest to be paid if the borrowers do not pay their accounts by a specified date, the taxpayer would be required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool.

The proposal would operate as follows. Assume that a calendar year taxpayer issues credit cards, the terms of which provide that if charges for a calendar month are paid within 30 days after the close of the month, no interest will accrue with respect to such charges. However, if the balances are not paid within this 30-day grace period, interest will accrue from the date of the charge until the balance is paid. Further assume that the taxpayer issues a significant number of such credit cards and the card holders incur charges of \$10 million in December 1997. Under present law (depending upon the taxpayer's accounting method), the taxpayer is not required to include any interest income in 1997 with respect to the December charges because it is possible that all the credit card holders will pay off the \$10 million cumulative December balance by January 30, 1998, and therefore will not be subject to interest with respect to such charges. If some of the credit card holders do not pay their December charges by January 30, 1998, the balances of those holders will be subject to interest charges under the terms of the credit cards and the taxpayer would accrue such interest in income in 1998. Under the proposal, the taxpayer, in computing its 1997 taxable income, would be required to make a reasonable assumption as to what portion of the \$10 million balances will not be paid off within the 30-day grace period and would be required to accrue interest income through December 31, 1997, with respect to such portion. The taxpayer would then adjust such accrual in 1998 to reflect the extent to which such prepayment assumption reflected the actual payments received in January.

In addition, the Secretary of the Treasury would be authorized to provide appropriate exemptions from the proposal, including exemptions for taxpayers that hold a limited amount of debt instruments, such as small retailers.

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. It is expected that the Secretary of the Treasury would not grant changes in methods of accounting to taxpayers that presently follow a method of accounting described in the proposal with respect to taxable years beginning before the date of enactment.

5. 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 and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction of at least 70 percent of the amount of the dividend). 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.

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 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 also would 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. This proposal would not affect the treatment of a holder of an instrument.

The proposal is not intended to affect the characterization of instruments as debt or equity under current law; and no inference is intended as to the treatment of any instrument under current law.

Effective Date

The proposal would be effective for instruments issued after June 8, 1997, but would not apply to such instruments (1) issued pursuant to a written agreement which 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.

B. Corporate Organizations and Reorganizations

1. 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.⁷⁰ Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.⁷¹

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

⁷⁰ See H. Rept. 99-841, II-166, 99th Cong. 2d Sess. (September 18, 1986).

⁷¹ See Treas. reg. sec. 1.701-2(f), Example (2).

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)).

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.⁷²

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 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 proposal.

Effective Date

The proposal generally would be effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on May 3, 1995 and at all times thereafter before such distribution, or a tender offer outstanding on May 3, 1995.⁷³ However, in

⁷² 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.

⁷³ 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.

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.

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

Present Law

A corporation generally is 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.

In cases where the form of the transaction involves a contribution of assets to the particular controlled corporation that is distributed in connection with the distribution, there are specific Code requirements that distributing corporation's shareholders own "control" of the distributed corporation immediately after the distribution. Control is defined for this purpose as 80 percent of the voting power of all classes of stock entitled to vote and 80 percent of each other class of stock. (Sections 368(a)(1)(D), 368(a)(2)(H), and 351(a) and (c)). In addition, it is a requirement for qualification of any section 355 distribution that the distributing corporation distribute control of the controlled corporation (defined by reference to the same 80-percent test).⁷⁴

⁷⁴ If a controlled corporation is acquired after a distribution, an issue may arise whether under step-transaction concepts, the acquisition can be viewed as having occurred before the distribution, with the result that the distributing corporation would not be viewed as having distributed the necessary 80 percent control. The Internal Revenue Service has indicated that it will not rule on requests for section 355 treatment in cases in which there have been negotiations, agreements, or arrangements with respect to transactions or events which, if consummated before the distribution, would result in the distribution of stock or securities of a corporation which is not "controlled" by the distributing corporation. Rev. Proc. 96-39, 1996-33 I.R.B. 11; see also Rev. Rul. 96-30, 1996-1 C.B. 36; Rev. Rul. 70-225, 1970-1 C.B. 80.

Present law has the effect of imposing more restrictive requirements on certain types of acquisitions or other transfers following a distribution if the company involved is the controlled corporation rather than the distributing corporation.

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, if, pursuant to a plan or arrangement in existence on the date of distribution, either the controlled or distributing corporation is acquired, gain would be recognized by the other corporation as of the date of the distribution.

In the case of an acquisition of a controlled corporation, the amount of gain recognized by the distributing corporation would be the amount of gain that the distributing corporation would have recognized had stock of the controlled corporation been sold for fair market value on the date of distribution. In the case of an acquisition of the distributing corporation, the amount of gain recognized by the controlled corporation would be the amount of net gain that the distributing corporation would have recognized had it sold its assets for fair market value immediately after the distribution. This gain would be treated as long-term capital gain. No adjustment to the basis of the stock or assets of either corporation would be allowed by reason of the recognition of the gain.

Whether a corporation is acquired would be determined under rules similar to those of present law section 355(d), except that acquisitions would not be restricted to "purchase" transactions. Thus, an acquisition would occur if a person (or persons acting in concert) acquired 50 percent or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan or arrangement. For example, assume a corporation ("P") distributes the stock of its wholly owned subsidiary ("S") to its shareholders. If, pursuant to a plan or arrangement, 50 percent or more of the vote or value of either P or S is acquired by a person or persons acting in concert, the proposal would require gain recognition by the corporation not acquired. Except as provided in Treasury regulations, if the assets of the distributing or controlled corporation are acquired by a successor in a merger or other transaction under section 368(a)(1)(A), (C) or (D) of the Code, the shareholders (immediately before the acquisition) of the corporation acquiring such assets shall be treated as acquiring stock in the corporation from which the assets were acquired. Under Treasury regulations, other asset transfers also could be subject to this rule.⁷⁵ However, in any transaction, stock received directly or indirectly by former shareholders of distributing or controlled, in a successor or new controlling corporation of either, would not be treated as acquired stock if it is attributable to such shareholders' stock in distributing or controlled that was

⁷⁵ As one example, a section 351 transaction in which a corporation contributed all its assets to another corporation but received a less than 50 percent interest in the vote or value of the stock of the transferee would be expected to be covered by such Treasury regulations.

not acquired as part of a plan or arrangement to acquire 50 percent or more of such successor or other corporation.

Acquisitions occurring within the four-year period beginning two years before the date of distribution would be presumed to have occurred pursuant to a plan or arrangement. Taxpayers could avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution.

The proposal would not apply to distributions that would otherwise be subject to section 355(d) of present law, which imposes corporate level tax on certain disqualified distributions:

The proposal would not apply to a distribution pursuant to a title 11 or similar case.

The Treasury Department would be authorized to prescribe regulations as necessary to carry out the purposes of the proposal, including regulations to provide for the application of the proposal in the case of multiple transactions.

Except as provided in regulations, in the case of distributions within an affiliated group of corporations within the meaning of section 1504(a) (whether or not filing a consolidated return), section 355 would not apply to any distribution within the group.

The proposal also would modify certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and section 368(a)(2)(H) with respect to reorganizations under section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation would be treated as in control of the distributed corporation immediately after the distribution if they hold stock representing at least a 50 percent or greater interest in the vote and value of stock of the distributed corporation.

The proposal does not change the present-law requirement under section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of controlled. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the proposal regarding plans that permit certain types of planned restructuring of distributing following the distribution, and to treat similar restructurings of controlled in a similar manner. Thus, the 80-percent control requirement would be expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

Effective Date

The proposal would generally be effective for distributions after April 16, 1997. However, the part of the proposal providing a 50-percent control requirement immediately after certain

section 351 and 368(a)(1)(D) distributions would be effective for transfers after the date of enactment.

No part of the proposal would apply to a distribution (or transfer, as the case may be) after April 16, 1997, if such distribution or transfer is (1) made pursuant to a written agreement which 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 on or before such date in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the distribution. Any written agreement, ruling request, or public announcement would not be within the scope of these transition provisions unless it identifies the unrelated acquiror of the distributing corporation or of any controlled corporation, whichever is applicable.

3. 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 sec, 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 controlled 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 would be effective for distributions or acquisitions after June 8, 1997 except that the proposal would not apply to any such distribution or acquisition (1) made pursuant to a written agreement which 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.

4. Modify holding period for dividends-received deduction

Present Law

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

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 paid or accrued after the 30th day after the date of the enactment of the provision.

C. Other Corporate Provisions

1. Registration of confidential corporate tax shelters and substantial understatement penalty

Present Law

Tax shelter registration

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)).

Accuracy-related penalty

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.

The substantial understatement penalty applies in the following manner. If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there was a reasonable basis for the tax treatment of the item. Special rules apply to tax shelters.

With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. The reduction in the understatement for items disclosed on the return is inapplicable to both corporate and non-corporate tax shelters. For this purpose, a tax shelter is a partnership or other entity, plan, or arrangement the principal purpose of which is the avoidance or evasion of Federal income tax.

The Secretary may waive the penalty with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

Description of Proposal

Tax shelter registration

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.

Substantial understatement penalty

The proposal would make two modifications to the substantial understatement penalty. The first modification would affect the reduction in the amount of the understatement which is attributable to an item if there is a reasonable basis for the treatment of the item. The proposal would provide that in no event would a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation. No inference is intended that such a multi-party financing transaction could not also be a tax-shelter as defined under the modification described below or under current law.

The second modification would affect the special tax shelter rules, which define a tax shelter as an entity the principal purpose of which is the avoidance or evasion of Federal income tax. The proposal would instead provide that a significant purpose (rather than the principal purpose) of the entity must be the avoidance or evasion of Federal income tax for the entity to be considered a tax shelter. This modification would conform the definition of tax shelter for

purposes of the substantial understatement penalty to the definition of tax shelter for purposes of these new confidential corporate tax shelter registration requirements.

Treasury report

The proposal would also direct the Treasury Department, in consultation with the Department of Justice, to issue a report to the tax-writing committees on the following tax shelter issues: (1) a description of enforcement efforts under section 7408 of the Code (relating to actions to enjoin promoters of abusive tax shelters) with respect to corporate tax shelters and the lawyers, accountants, and others who provide opinions (whether or not directly addressed to the taxpayer) regarding aspects of corporate tax shelters; (2) an evaluation of whether the penalties regarding corporate tax shelters are generally sufficient; and (3) an evaluation of whether confidential tax shelter registration should be extended to transactions where the investor (or potential investor) is not a corporation. The report would be due one year after the date of enactment.

Effective Date

The tax shelter registration 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. The modifications to the substantial understatement penalty would apply to items with respect to transactions entered into after the date of enactment.

2. 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 (secs. 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 secs. 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) would 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, if neither the stock surrendered nor the stock received in the exchange is stock of a corporation any class of stock of which (or of a related corporation) is publicly traded, a right or obligation would be disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder. Also, a right or obligation would be disregarded in the case of stock transferred in connection with the performance of services if it may be exercised only upon the holder's separation from service.

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 would continue to 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., secs. 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code.

Effective Date

The proposal would be effective for transactions after June 8, 1997, but would not apply to such transactions (1) made pursuant to a written agreement which 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.

D. Administrative Provisions

1. 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. Treasury regulation section 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 Treasury regulation section 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 be 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, 1997. Consequently, the first information reports would be filed with the IRS (and copies will be provided to recipients of the payments) in 1999, with respect to payments made in 1998.

2. 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. sec. 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. sec. 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.

3. 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 permanently extend the DVA disclosure provision.

Effective Date

The proposal would be effective on the date of enactment.

4. Establish IRS continuous levy and improve debt collection

a. Continuous levy

Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand⁷⁶ by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,⁷⁷ unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.⁷⁸

In general, a levy does not apply to property acquired after the date of the levy,⁷⁹ regardless of whether the property is held by the taxpayer or by a third party (such as a bank) on behalf of a taxpayer. Successive seizures may be necessary if the initial seizure is insufficient to satisfy the liability.⁸⁰ The only exception to this rule is for salary and wages.⁸¹ A levy on salary and wages is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

A minimum exemption is provided for salary and wages.⁸² It is computed on a weekly basis by adding the value of the standard deduction plus the aggregate value of personal exemptions to which the taxpayer is entitled, divided by 52.⁸³ For a family of four for taxable year 1996, the weekly minimum exemption is \$325.⁸⁴

⁷⁶ Notice and demand is the notice given to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be mailed to the person's last known address or left at the person's dwelling or usual place of business (Code sec. 6303).

⁷⁷ Code sec. 6331.

⁷⁸ Code secs. 6335-6343.

⁷⁹ Code sec. 6331(b).

⁸⁰ Code sec. 6331(c).

⁸¹ Code sec. 6331(e).

⁸² Code sec. 6334(a)(9).

⁸³ Code sec. 6334(d).

⁸⁴ Standard deduction of \$6,700 plus four personal exemptions at \$2,550 each equals \$16,900, which when divided by 52 equals \$325.

Description of Proposal

The proposal would amend the Code to provide that a continuous levy is also applicable to non-means tested recurring Federal payments. This is defined as a Federal payment for which eligibility is not based on the income and/or assets of a payee. For example, Social Security payments, which are subject to levy under present law, would become subject to continuous levy.

In addition, the proposal would provide that this levy would attach up to 15 percent of any salary or pension payment due the taxpayer. This rule would explicitly replace the other specifically enumerated exemptions from levy in the Code. Under the proposal, the continuous levy could apply to the entire amount of a Federal payment that is not salary or a pension payment. Under the proposal, a continuous levy of up to 15 percent could also apply to unemployment benefits and means-tested public assistance.

The proposal also would permit the disclosure of otherwise confidential tax return information to the Treasury Department's Financial Management Service only for the purpose of, and to the extent necessary in, implementing these levy provisions.

Effective Date

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

b. Modifications of levy exemptions

Present Law

The Code exempts from levy workmen's compensation payments⁸⁵ annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act⁸⁶ described above, unemployment benefits⁸⁷ and means-tested public assistance.⁸⁸

Description of Proposal

The proposal would provide that the following property is not exempt from levy if the Secretary of the Treasury (or his delegate) approves the levy of such property:

⁸⁵ Code sec. 6334(a)(7).

⁸⁶ Code sec. 6334(a)(6).

⁸⁷ Sec. 6334(a)(4).

⁸⁸ Sec. 6334(a)(11).

- (1) workmen's compensation payments;⁸⁹
- (2) annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act;
- (3) unemployment benefits; and
- (4) means-tested public assistance.

Effective Date

The proposal would apply to levies issued after the date of enactment.

5. Consistency rule for beneficiaries of trusts and estates

Present Law

An S corporation is required to file a return for the taxable year and is required to furnish to its shareholders a copy of certain information shown on such return. The shareholder is required to file its return in a manner that is consistent with the information received from the S corporation, unless the shareholder files with the Secretary of the Treasury a notification of inconsistent treatment (sec. 6037(c)). Similar rules apply in the case of partnerships and their partners (sec. 6222).

The fiduciary of an estate or trust that is required to file a return for any taxable year is required to furnish to beneficiaries certain information shown on such return (generally via a Schedule K-1) (sec. 6034A). In addition, a U.S. person that is treated as the owner of any portion of a foreign trust is required to ensure that the trust files a return for the taxable year and furnishes certain required information to each U.S. person who is treated as an owner of a portion of the trust or who receives any distribution from the trust (sec. 6048(b)). However, rules comparable to the consistency rules that apply to S corporation shareholders and partners in partnerships are not specified in the case of beneficiaries of estates and trusts.

Description of Proposal

Under the proposal, a beneficiary of an estate or trust would be required to file its return in a manner that is consistent with the information received from the estate or trust, unless the beneficiary files with its return a notification of inconsistent treatment identifying the inconsistency.

⁸⁹ Many workmen's compensation payments are made by States. The heading of the new subsection of the Code (but not the text of the subsection itself) refers to "Federal" payments. A clarification of this matter may be desirable.

Effective Date

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

6. Informational returns on real estate transactions

Present Law

Persons who close real estate transactions are required to file informational returns with the IRS. These returns, filed on Form 1099S, are required to show the name and address of the buyer and seller of the real estate, details with regard to the gross proceeds of the sale, the portion of any real property tax which is treated as a tax imposed on the purchaser, and whether or not any financing of the seller was federally-subsidized indebtedness.

Description of Proposal

The proposal would exclude sales of personal residences with a gross sales price of \$500,000 or less (\$250,000 or less in the case of a seller whose filing status is not married, filing jointly) from the real estate transaction reporting requirement, provided the person who would otherwise be required to file the informational return obtains written assurances from the seller of the real estate that any gain will be exempt from Federal income tax under section 121 and that no financing of the seller was federally-subsidized indebtedness.

Effective Date

The proposal would be effective for informational returns otherwise required with regard to real estate sales occurring after the date of enactment.

E. Excise Tax Provisions

1. Extension and modification of Airport and Airway Trust Fund excise taxes

Present Law

Present law imposes a variety of excise taxes on air transportation to finance the Airport and Airway Trust Fund programs administered by the Federal Aviation Administration (the "FAA"). In general, the full cost of FAA capital programs is financed from the Airport and Airway Trust Fund while only a portion of FAA operational expenses is Trust Fund-financed. Overall, the portion of total FAA expenditures that has been financed from the Trust Fund has declined from 75 percent through the early 1990s to 62 percent for the 1997 fiscal year. The balance is financed by general taxpayers, rather than directly by program users. Each of the Airport and Airway Trust Fund excise taxes is scheduled to expire after September 30, 1997.

Commercial air passenger transportation taxes

Domestic air passenger transportation is subject to an ad valorem excise tax equal to 10 percent of the amount paid for the transportation. Taxable domestic air transportation includes both travel within the United States and certain travel between the United States and points in Canada or Mexico that are within 225 miles of the U.S. border (the "225-mile zone").

International air passenger transportation is subject to a \$6 departure excise tax imposed on passengers departing the United States for other countries. No tax is imposed on passengers arriving in the United States from other countries. International transportation is defined to include separate domestic flights that connect to international flights, provided that stopover time at any point within the United States does not exceed 12 hours. Thus, these "domestic legs" associated with international transportation (e.g., a flight from Los Angeles to New York from which the passenger boards a connecting flight to London) are exempt from the 10-percent ad valorem excise tax otherwise imposed on such transportation between two domestic points.

Because both the domestic and international air passenger excise taxes are imposed only on transportation for which an amount is paid, no tax is imposed on "free" travel (e.g., frequent flyer travel and airline industry employee travel for which the passenger is not directly charged) even if third parties (e.g., credit card companies) make cash or in kind payments for the right to award the "free" or reduced-rate travel to their customers.

The air passenger transportation excise taxes are imposed on passengers; transportation providers (generally airlines) are responsible for collecting and remitting the taxes to the Federal Government. In general, both the domestic and international air passenger transportation excise taxes are imposed without regard to whether the transportation is purchased within the United States. An exception provides that travel between the United States and the 225-mile zone is subject to the ad valorem domestic tax only if it is purchased within the United States.

The Code requires all advertising for taxable air passenger transportation either (1) to state the fare on a tax-inclusive basis or (2) if the Federal tax is stated separately, to state the amount of the tax at least as prominently as the underlying airline fare and to identify that amount as "user taxes to pay for airport construction and airway safety and operations" (sec. 7275(b)).

The amount of air passenger transportation excise tax collected from a passenger must be stated separately on the ticket.

Commercial air cargo transportation

Domestic air cargo transportation is subject to a 6.25-percent ad valorem excise tax. This tax, like the air passenger excise taxes, is imposed on the consumer, with the transportation provider being required to collect and remit the tax to the Government. However, there is no requirement that the tax be stated separately on shipping invoices.

Noncommercial aviation

Noncommercial aviation, or transportation on private aircraft which is not "for hire," is subject to excise taxes imposed on fuel in lieu of the commercial air passenger ticket and air cargo excise taxes. The current Airport and Airway Trust Fund tax rates on these fuels are 15 cents per gallon on aviation gasoline and 17.5 cents per gallon on jet fuel.

The aviation gasoline excise tax is imposed on removal of the fuel from a registered terminal facility (the same point as the highway gasoline excise tax). The jet fuel excise tax is imposed on sale of the fuel by a wholesale distributor. Many larger airports have dedicated pipeline facilities that directly service aircraft; in such a case, the tax effectively is imposed at the retail level. The person removing the gasoline from a terminal facility or the wholesale distributor of the jet fuel is liable for these taxes.

Overflight user fees

Non-tax user fees are imposed on air transportation (both commercial and noncommercial aviation) that travels through airspace for which the United States provides air traffic control services, but that neither lands in nor takes off from a point in the United States. These fees are imposed and collected by the FAA with respect to mileage actually flown, and apply both to travel within U.S. territorial airspace and to travel within international oceanic airspace for which the United States is responsible for providing air traffic control services.

Description of Proposal

Extension of Airport and Airway Trust Fund taxes

The Airport and Airway Trust Fund excise taxes, as modified below, would be extended for 10 years, for the period October 1, 1997, through September 30, 2007. The taxes that would be extended include the domestic and international air passenger excise taxes, the air cargo excise tax, and the noncommercial aviation fuels taxes. Gross receipts from the taxes would continue to be deposited in the Airport and Airway Trust Fund.

Modification of commercial air passenger transportation taxes

Modify tax rates.--The current 10-percent domestic air passenger excise tax would be changed to a tax equal to the total of 7.5 percent of the gross amount paid by the passenger for the transportation plus a \$2.00 fixed dollar amount per flight segment. The fixed dollar amount per flight segment would be increased each January 1 for a four-year period, as follows:

<u>Calendar year</u>	<u>Per flight segment charge</u>
1999	\$ 2.25
2000	2.50
2001	2.75
2002	3.00

Beginning on January 1, 2003, and each January 1 thereafter, the fixed dollar amount per flight segment would be indexed annually for inflation occurring after 2001, measured by changes in the Consumer Price Index (the "CPI") rounded to the nearest 10 cents. Inflation adjustments would be effective for transportation provided beginning after December 31, 2002, and in each subsequent calendar year.

The term flight segment would be defined as transportation involving a single take-off and a single landing.⁹⁰ All transportation between points within the 48 contiguous States (and within Hawaii or Alaska), including separate domestic segments associated with international transportation, would be subject to tax at the 7.5 percent and \$2.00 rates.

The current \$6 international departure tax would be increased to \$10 per departure, and an identical \$10 per passenger tax would be imposed on arrivals in the United States from international locations. The international departure and arrival taxes would be indexed for inflation occurring after 1997, measured by changes in the CPI rounded to the nearest 10 cents.

⁹⁰ For example, travel from New York to San Francisco, with an intermediate stop in Chicago, would consist of two flight segments (without regard to whether the passenger changed aircraft in Chicago).

Inflation adjustments would be effective for transportation provided beginning after December 31, 1998, and each subsequent calendar year.

As under present law, certain air transportation between the United States and points within the 225-mile zone of Canada or Mexico would be taxed as domestic transportation subject to the 7.5 percent and \$2.00 rates. The present-law rules classifying transportation between the 48 contiguous States and Alaska or Hawaii (or between those States) as part domestic and part international would be retained, without change, other than a clarification that a single flight segment between the 48 contiguous States and Alaska or Hawaii (or between those States) is subject to only one \$10 per passenger international tax despite the fact that the flight both departs into and arrives from international airspace.

Transportation that involves both a domestic flight segment and an uninterrupted international flight segment between a point in the United States and a point outside the United States would be taxed separately on the domestic flight segment and the international flight segment. (For this purpose, segments between the United States and points within the 225-mile zone would be considered domestic segments if the transportation is purchased within the United States; otherwise, such segments would be considered international flight segments.) For the domestic segment of an international flight, the portion of the total fare that would be subject to the ad valorem rate would be based on the number of miles in the domestic flight segment as compared to the total number of miles traveled on all flight segments covered by the fare. For example, for transportation from Minneapolis to Tokyo, with an intermediate stop in Seattle, the flight segment from Minneapolis to Seattle would be subject to a tax equal to 7.5 percent of the fare allocated to that segment, plus the \$2.00 per-flight-segment charge. The portion of the transportation from Seattle to Tokyo would be subject to a tax equal to \$10 per passenger. Great Circle miles would be used in making this point-to-point mileage calculation unless the Treasury Department determines that another measure more accurately reflects the routes actually flown. The airline would calculate and pay this tax and show a single, aggregate tax amount on the passenger's ticket.

Extension of tax to certain currently exempt passengers. --As described above, the domestic tax base would be expanded to include domestic segments flown by passengers connecting to or from international flight segments. Additionally, passengers arriving in the United States from other countries, who currently are the only group of travelers whose transportation is subject neither to an excise tax nor a user fee for U.S.-provided aviation services, would be subject to tax on their arriving international flight segment.

Clarification further would be provided that any amounts paid to air carriers (in cash or in kind) for the right to award free or reduced-rate air transportation would be treated as amounts paid for taxable air transportation, subject to the 7.5 percent ad valorem tax rate. Examples of such taxable amounts include (1) payments for frequent flyer miles purchased by credit card companies, telephone companies, rental car companies, and other businesses for distribution to their customers and (2) amounts received by airlines pursuant to joint venture credit card or other marketing arrangements. The Treasury Department would be authorized specifically to disregard

accounting allocations or other arrangements which have the effect of reducing artificially the base to which the 7.5-percent tax is applied.

Advertising requirements.--The Code advertising requirements would be modified to mandate that the Federal air transportation tax be stated separately. The tax would have to be stated proximate to the airfare in type at least 50 percent as large as the fare is stated, and be identified as a user tax as required under present law.

Liability for tax.--The present-law provision imposing liability for the tax on passengers (with transportation providers being liable for collecting and remitting revenues to the Federal Government) would be modified to impose secondary liability on air carriers. As with the current tax, the aggregate tax would continue to be required to be stated separately on passenger tickets.

Effective Date

The proposal generally would be effective on the date of enactment, for air transportation beginning after September 30, 1997.

Present law requires transportation providers to continue collecting the commercial aviation excise taxes (at the current rates) on transportation to be provided after September 30, 1997, if the transportation is purchased before October 1, 1997. The proposal would require transportation providers to collect the taxes at the modified rates for transportation purchased after the date of enactment for travel beginning after September 30, 1997.

2. Extend diesel fuel excise tax rules to kerosene

Present Law

Diesel fuel used as a transportation motor fuel generally is taxed at 24.3 cents per gallon. 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 commonly is 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.

Aviation gasoline and jet fuel (both commercial and noncommercial use) currently are subject to a 4.3-cents-per-gallon General Fund tax rate. In addition, through September 30, 1997, gasoline and jet fuel used in noncommercial aviation are subject to an additional 15-cents-per-gallon rate (gasoline) and 17.5-cents-per-gallon rate (jet fuel) for the Airport and Airway Trust Fund. These combined rates produce an aggregate tax of 21.8 cents per gallon on noncommercial aviation jet fuel and 19.3 cents per gallon on noncommercial aviation gasoline. 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 things, prevent gelling of the diesel fuel in colder temperatures. Under present law, kerosene is not subject to excise 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. Although heating oil often has minor amounts of kerosene blended with it in colder weather, this blending typically occurs before removal of the fuel from the terminal facilities where Federal excise taxes are imposed. However, it may be necessary during periods of extreme or unseasonably cold weather to add kerosene to heating oil after its removal from the terminal. Other nontaxable uses of kerosene include feedstock use in the petrochemical industry.

Description of Proposal

Kerosene would be subject to the same excise tax rules as diesel fuel. Thus, kerosene would be taxed when it is removed from a registered terminal unless it is indelibly dyed and destined for a nontaxable use. However, aviation-grade kerosene that is removed from the terminal by a registered producer of aviation fuel would not be subject to the dyeing requirement and would be taxed under the present law rules applicable to aviation fuel. Feedstock kerosene that a registered industrial user receives by pipeline or vessel also would be exempt from the dyeing requirement. Other feedstock kerosene would be exempt from the dyeing requirement to the extent and under conditions (including satisfaction of registration and certification requirements) prescribed by Treasury Department regulation.

To accommodate State safety regulations that require the use of clear (K-1) kerosene in certain space heaters, a refund procedure would be provided under which registered ultimate vendors could claim refunds of the tax paid on kerosene sold for that use. In addition, the Internal Revenue Service would be given discretion to refund to a registered ultimate vendor the tax paid on kerosene that is blended with heating oil for use during periods of extreme or unseasonable cold.

Effective Date

The proposal would be effective for kerosene removed from terminal facilities after June 30, 1998. Appropriate floor stocks taxes would be imposed on kerosene held beyond the point of taxation on July 1, 1998.

3. Modify tax benefits for ethanol and renewable source methanol

Present Law

Present law provides a 54-cents-per-gallon income tax credit for ethanol and a 60-cents-per-gallon income tax credit for methanol produced from renewable sources (e.g., biomass) that are used as a motor fuel or that are blended with other fuels (e.g., gasoline) for such a use. As an alternative to claiming the income tax credits directly, these tax benefits may be claimed as a reduction in the amount of excise tax paid on gasoline or diesel fuel with which the ethanol or renewable source methanol are blended or as a reduction in the special motor fuels rate applicable to "neat" ethanol or renewable source methanol fuels. The excise tax delivery of the benefits occurs either through reduced tax rate sales to registered blenders of e.g., gasoline or diesel fuel, or through expedited refunds of gasoline or diesel fuel tax paid.

In addition to these general ethanol benefits, a separate 10-cents-per-gallon credit is provided for small ethanol producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. No comparable small producer credit is provided for small renewable source methanol producers.

Treasury Department regulations provide that ethyl tertiary butyl ether ("ETBE"), which is made using ethanol, qualifies for the blender income tax credit and the excise tax exemption.

The alcohol fuels tax benefits are scheduled to expire after December 31, 2000. The provision allowing the ethanol blender benefits to be claimed through the motor fuels excise tax system is scheduled to expire after September 30, 2000.

Description of Proposal

The proposal would retain the current blender ethanol (at a reduced level) and renewable source methanol benefits through their scheduled expirations in 2000, but would limit the amount of production of these fuels eligible for tax benefits. The proposal also would clarify that ETBE and similar ethers are not eligible for the alcohol fuel tax benefits.

Limit on production eligible for tax benefits

The alcohol fuels income tax credits (other than the small ethanol producer tax credit) and the excise tax exemptions for ethanol and methanol from renewable sources would be available only for alcohol fuels produced by distilling equipment placed in service before June 9, 1997.⁹¹ Additionally, producers other than small producers (defined as under present law) would receive

⁹¹ Property placed in service after June 8, 1997, pursuant to a binding contract entered into before June 9, 1997, would be treated as if placed in service before June 9, 1997.

these benefits only to the extent that annual production after December 31, 1997, does not exceed average annual production of fuel alcohol by the equipment during a prescribed three-year period (the "eligible production ceiling"). The eligible production ceiling would be determined first by ascertaining annual production during each year of the five-year period ending on May 31, 1997. The year when production was the greatest and the year when production was the lowest would be eliminated. The production ceiling would equal the average of the annual production during the remaining three years. A safe-harbor production level equal to 50 percent of capacity as of June 8, 1997, would be provided.

To ensure that only eligible production continues to receive the blender tax benefits after the date of the proposal's enactment, an "excess production penalty" would be imposed on all production from equipment placed in service after June 8, 1997, and on production from existing equipment (by producers other than small producers) that exceeds the producer's eligible production ceiling. Beginning on January 1, 2001, all ethanol production would be treated as "excess" production, but the penalty would not apply during any period when no ethanol or renewable source methanol tax benefits were statutorily available. The penalty would be non-deductible for Federal income tax purposes. Receipts from the penalty would be deposited in the Highway Trust Fund. The penalty would offset the benefit provided to excess production by the current general income tax and excise tax provisions; therefore, no changes (other than those described herein) would be made to those provisions. Thus, blenders would remain eligible to claim the tax benefits in the same manner as provided under present law, through 2000.

Reduce ethanol tax benefits to reflect carbon dioxide by-product value; offset for small producers

Carbon dioxide is a naturally occurring by-product of ethanol production. This carbon dioxide is commercially valuable and currently is being captured and sold by ethanol producers. The 54-cents-per-gallon ethanol income tax credit and the 5.4-cents-per-gallon ethanol excise tax exemptions would be reduced to 51 cents per gallon and 5.1 cents per gallon, respectively, to reflect the value of carbon dioxide recovered as a by-product in ethanol production.

The present-law small ethanol producers credit would be increased from 10 cents per gallon to 13 cents per gallon to offset the effect of this reduction for small producers.

ETBE and similar ethers not to qualify

Statutory clarification would be provided that ETBE and similar ethers (and alcohol used to produce these ethers) are not qualified alcohol fuels for either the ethanol or methanol from renewable sources tax benefits.

Effective Date

Limit on eligible production

The provision limiting production eligible for the alcohol fuels tax benefits to production from facilities placed in service before June 9, 1997, would be effective on the date of enactment. The production limits applicable to such grandfathered facilities would be effective for production occurring after December 31, 1997.

Reduce ethanol tax benefits to reflect carbon dioxide by-product value

The reduction in the ethanol blenders credit and excise tax exemption to reflect the value of carbon dioxide produced as a by-product and the offsetting increase in the small producer's income tax credit would be effective on January 1, 1998.

ETBE and similar ethers not to qualify

The provision reversing the Treasury Department regulations defining ethers as qualified alcohol fuels would be effective for ethers produced after December 31, 1997.

F. Provisions Relating to Tax-Exempt Organizations

1. Treatment of Indian tribal organizations under the unrelated business income tax

Present Law

Tax treatment of Indian tribes

There is no specific statutory provision governing the Federal income tax liability of Indian tribes.⁹² However, the Internal Revenue Service (IRS) has long taken the position that Indian tribes, as well as wholly owned tribal corporations chartered under Federal law, are not taxable entities and, thus, are immune from Federal income taxes. (See Rev. Rul. 67-284, 1967-2 C.B. 55; Rev. Rul. 81-295, 1981-2 C.B. 15.) More recently, the IRS has ruled that any income earned by an unincorporated Indian tribe or Federally chartered tribal corporation is not subject to Federal income tax, regardless of whether the activities that produced the income are conducted on or off the tribe's reservation. (See Rev. Rul. 94-16, 1994-12 I.R.B. 1; Rev. Rul. 94-65, 1994-42 I.R.B. 10.⁹³) However, Indian tribes are subject to certain Federal excise taxes with respect to their commercial activities that are not part of an essential governmental function. In ordinary matters not governed by specific treaties or remedial legislation, individual members of Indian tribes are subject to the payment of Federal income tax (even if the income is distributed to individual tribal members out of income otherwise immune from tax when first received by the tribe).⁹⁴

⁹² Section 7871 provides that Indian tribes are treated as States for certain limited tax purposes, such as for purposes of the issuance of certain tax-exempt bonds, certain excise tax exemptions, and for eligibility to receive deductible charitable contributions.

⁹³ These rulings further hold, however, that a corporation organized by an Indian tribe under State law is subject to Federal income tax on the income earned from commercial activities conducted on or off the tribe's reservation.

Legal commentators generally have concluded that "[u]nder this so-called Indian Commerce Clause [article I, section 8 of the Constitution] and Supreme Court cases, there is little constitutional limitation on the ability of the Federal government to tax Indian tribes or tribal members." Aprill, Ellen P., "Tribal Bonds: Indian Sovereignty and the Tax Legislative Process," 46 Admin. L. Rev. 333, 334 (1994).

⁹⁴ See Squire v. Capoeman, 351 U.S. 1, 6 (1956). One exception to this general rule is the exclusion from income provided for income received by Indians from the exercise of certain fishing rights guaranteed by treaties, Federal statute or Executive order (sec. 7873). See also 25 U.S.C. sections 1401-1407 (funds appropriated in satisfaction of a judgment of the United States Court of Federal Claims in favor of an Indian tribe which are then distributed per capita to tribal members pursuant to a plan approved by the Secretary of Interior are exempt from Federal income taxes); 25 U.S.C. section 117b(a) (per capita distributions made to tribal members from Indian trust fund revenues are exempt from tax if the Secretary of the Interior approves of such

Tribal governments and corporations, as well as individual Indians and their property, generally are exempt from State taxation within their reservations, unless Congress clearly manifests its consent to such taxation.⁹⁵ In contrast, property and income earned by Indians outside the reservation generally have been held to be subject to State taxation.⁹⁶ In addition, the Supreme Court has upheld a State's right to impose taxes on commercial activities conducted on reservation lands, provided that the legal incidence of the tax falls on non-Indians and the balance of Federal, State, and tribal interests favors the State.⁹⁷

In 1993, Congress enacted two Federal tax incentives for commercial activities conducted (by Indians or non-Indians) on any Indian reservation. These tax incentives are: (1) enhanced accelerated depreciation (generally, 60 percent of the normal recovery period) for certain property used in the conduct of a trade or business on a reservation (and certain connecting infrastructure property); and (2) a 20-percent incremental wage credit for wages and health insurance costs (up to \$20,000 per employee) paid to tribal members and spouses who work on, and live on or near, a reservation.⁹⁸ Neither of these tax incentives is available with respect to gambling activities (secs. 45A and 168(j)).

Taxation of unrelated business income of nonprofit organizations

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax (UBIT) on income derived from a trade or business regularly

distributions).

The IRS recently concluded that per capita payments made by a tribe from gaming revenues, that are equal payments not based on the personal situation of the recipients, are includible in the recipients' gross income subject to Federal income tax (PLR 9717007).

⁹⁵ See, e.g., Oklahoma Tax Comm'n v. Chickasaw Nation, 115 S.Ct. 2214 (1995); Montana v. Blackfoot Tribe of Indians, 471 U.S. 759 (1985); McClanahan v. Arizona State Tax Comm'n, 411 U.S. 164 (1973).

⁹⁶ See, e.g., Mescalero Apache Tribe v. Jones, 411 U.S. 145 (1973)(tribe held to be subject to State gross receipts tax on income earned from a ski resort operated by the tribe off-reservation). The Supreme Court also has ruled that a State may impose income tax on members of an Indian tribe who are employed by the tribe on tribal lands but who reside in the State outside of Indian country. Oklahoma Tax Comm'n v. Chickasaw Nation, *supra*.

⁹⁷ See Oklahoma Tax Comm'n v. Chickasaw Nation, *supra*; Cotton Petroleum v. New Mexico, 490 U.S. 163 (1989)(upholding imposition of State severance tax on private producers of oil and gas on reservation lands).

⁹⁸ The wage credit is available only to the extent that the sum of current-year qualified wages and health costs exceeds the sum of comparable costs for 1993.

carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511-514).⁹⁹ Certain income, however, is exempted from the UBIT (such as interest, dividends, royalties, and certain rents), unless derived from debt-financed property (sec. 512(b)). Other exemptions from the UBIT are provided for activities in which substantially all the work is performed by volunteers and for income from the sale of donated goods (sec. 513(a)). In addition, a specific exemption from the UBIT is provided for bingo games¹⁰⁰ conducted by tax-exempt organizations, provided that the conducting of the bingo games is not an activity ordinarily carried out on a commercial basis and the conducting of which does not violate any State or local law (sec. 513(f)).¹⁰¹ A specific exemption from the UBIT also is provided for qualified public entertainment activities (meaning entertainment or recreation activities of a kind traditionally conducted at fairs or expositions promoting agricultural and educational purposes) conducted by an organization described in section 501(c)(3), (c)(4), or (c)(5) which regularly conducts an agricultural and educational fair or exposition as one of its substantial exempt purposes (sec. 513(d)).¹⁰²

In South End Italian Independent Club, Inc. v. Commissioner, 87 T.C. 168 (1986), acq. 1987-2 C.B. 1, the Tax Court held that gambling profits of a social club described in section 501(c)(7) that were required by State law to be used for charitable purposes were fully deductible under section 162 in computing the UBIT liability of the social club. The effect of this decision was to exempt gambling income of that social club from UBIT. The IRS has indicated that, until further guidance is available with respect to this issue, the issue of the deductibility of amounts required under State law to be used for charitable or other so-called "lawful" purposes should be resolved consistent with the South End case, regardless of whether the gaming proceeds are

⁹⁹ The UBIT applies not only to private, tax-exempt entities but also to colleges and universities that are agencies or instrumentalities of (or are owned or operated by) a State or local government or Indian tribal government (secs. 511(a)(2)(B) and 7871(a)(5)). In the case of such a college or university, the "substantially related" test is applied by determining whether the trade or business activity at issue is substantially related to the exercise or performance of any purpose or function described in section 501(c)(3) (see sec. 513(a)).

¹⁰⁰ For purposes of this exemption, the term "bingo game" is defined as any game of bingo of a type in which usually (1) the wagers are placed, (2) the winners are determined, and (3) the distribution of prizes or other property is made in the presence of all persons placing wagers in such game (sec. 513(f)(2)).

¹⁰¹ In 1978, at the same time that Congress enacted section 513(f), section 527 was modified to provide that bingo income of political organizations is to be treated as "exempt function income" and, thus, not subject to Federal income tax if such income is used for certain political purposes (sec. 527(c)(3)(D)).

¹⁰² In addition, section 311 of the Deficit Reduction Act of 1984 (as modified by the Tax Reform Act of 1986) provides a special, off-Code exemption from the UBIT for games of chance conducted by nonprofit organizations in the State of North Dakota.

donated to other charitable organizations or spent internally on the organization's own charitable activities.¹⁰³

Description of Proposal

Under the proposal, the unrelated business income tax (UBIT) would apply in the case of an "Indian tribal organization," meaning any Indian tribe or any organization that is generally exempt from Federal income tax and is owned or controlled by an Indian tribe. Thus, a trade or business activity conducted by an Indian tribal organization generally would be subject to the UBIT if the activity is regularly carried on and is not substantially related to the exercise or performance of any tax-exempt charitable (or other) purpose or function described in present-law section 501(c)(3). The proposal specifically would provide that no provision contained in the UBIT rules would be construed to exempt from UBIT liability any income derived by an Indian tribal organization directly or indirectly from class II or class III gaming activities, as defined under the Indian Gaming Regulatory Act (e.g., bingo, pull-tabs, lotto, or a casino operated pursuant to a compact between the State government and the Indian tribe).¹⁰⁴

The proposal would expand the present-law "convenience" exception contained in section 513(a)(2)--which currently applies to charities and to State, local, and tribal colleges and universities--so that the UBIT would not apply to any trade or business activity carried on by an Indian tribal organization primarily for the convenience of members of the tribe.

In addition, the proposal would provide that if, by reason of State or Federal law or of a contract with the United States or any State or local government, an Indian tribal organization is required to use any portion of the net proceeds of any activity for specified purposes, the deduction for so using such proceeds would be treated as a charitable contribution, the deduction for which could not exceed 10 percent of the taxable income from the activity (computed without regard to the deduction). This 10-percent limitation, however, would not apply to any proceeds which are paid as general revenues to the United States or any State or local government (any such proceeds generally would be fully deductible in computing the tribe's taxable income from the activity generating such proceeds).

Effective Date

The proposal would be effective on (and after) January 1, 1998.

¹⁰³ See IRS, Exempt Organizations: Technical Instruction Program for FY 1996 (Training 4277-048 (7-95)) at page 96.

¹⁰⁴ Thus, the present-law UBIT exception contained in section 513(f) for certain bingo games would not apply to Indian tribal organizations.

2. Extend UBIT rules to second-tier subsidiaries and amend control test

Present Law

In general, interest, rents, royalties and annuities are excluded from unrelated taxable business income (UBTI) of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBTI if such income is received from a taxable or tax-exempt subsidiary that is 80 percent controlled by the parent tax-exempt organization.¹⁰⁵ In the case of a stock subsidiary, the 80 percent control test is met if the parent organization owns 80 percent or more of the voting stock and all other classes of stock of the subsidiary.¹⁰⁶ In the case of a non-stock subsidiary, the applicable Treasury regulations look to factors such as the representation of the parent corporation on the board of directors of the nonstock subsidiary, or the power of the parent corporation to appoint or remove the board of directors of the subsidiary.¹⁰⁷

The control test under section 512(b)(13) does not, however, incorporate any indirect ownership rules.¹⁰⁸ Consequently, rents, royalties, annuities and interest derived from second-tier subsidiaries generally do not constitute UBTI to the tax-exempt parent organization.¹⁰⁹

Description of Proposal

¹⁰⁵ For this purpose, a "controlled organization" is defined under section 368(c). Under present law, rent, royalty, annuity, and interest payments are treated as UBTI when received by the parent organization based on the percentage of the subsidiary's income that is UBTI (either in the hands of the subsidiary if the subsidiary is tax-exempt, or in the hands of the parent organization if the subsidiary is taxable).

¹⁰⁶ Treas. reg. sec. 1.512(b)-1(l)(4)(I)(a).

¹⁰⁷ Treas. reg. sec. 1.512(b)-1(l)(4)(I)(b).

¹⁰⁸ See PLR 9338003 (June 16, 1993) (holding that because no indirect ownership rules are applicable under section 512(b)(13), rents paid by a second-tier taxable subsidiary are not UBTI to a tax-exempt parent organization). In contrast, an example of an indirect ownership rule can be found in Code section 318. Section 318(a)(2)(C) provides that if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly by or for such corporation, in the proportion the value of the person's stock ownership bears to the total value of all stock in the corporation.

¹⁰⁹ See PLR 9542045 (July 28, 1995) (holding that first-tier holding company and second-tier operating subsidiary were organized with bona fide business functions and were not agents of the tax-exempt parent organization; therefore, rents, royalties, and interest received by tax-exempt parent organization from second-tier subsidiary were not UBTI).

The proposal would modify the test for determining control for purposes of section 512(b)(13). Under the proposal, "control" would mean (in the case of a stock corporation) ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control would mean ownership of more than 50 percent of the profits, capital or beneficial interests.

In addition, the proposal would apply the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization would be deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

The proposal also would make technical modifications to the method provided in section 512(b)(13) for determining how much of an interest, rent, annuity, or royalty payment made by a controlled entity to a tax-exempt organization is includible in the latter organization's UBTI. Such payments would be subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

Effective Date

The modification of the control test to one based on vote or value, the application of the constructive ownership rules of section 318, and the technical modifications to the flow-through method would apply to taxable years beginning after the date of enactment. The reduction of the ownership threshold for purposes of the control test from 80 percent to more than 50 percent would apply to taxable years beginning after December 31, 1998.

3. Limitation on increase in basis of property resulting from sale by tax-exempt entity to related person

Present law

If a tax-exempt entity transfers assets to a controlled taxable entity in a transaction that is treated as a sale, the transferee taxable entity obtains a fair market value basis in the assets. Because the transferor is tax-exempt, no gain is recognized on the transfer except to the extent of certain unrelated business taxable income, if any.

Other provisions of the Code deny certain tax benefits when a transferor and transferee are related parties. For example, losses on sales between related parties are not recognized (sec. 267).

Description of Proposal

In the case of a sale or exchange of property directly or indirectly between a tax-exempt entity and a related person, the basis of the related person in the property would not exceed the adjusted basis of such property immediately before the sale in the hands of the tax-exempt entity,

increased by the amount of any gain recognized to the tax exempt entity under the unrelated business taxable income rules of section 511.

Related person would mean any person having a relationship to the tax-exempt entity described in section 267(b) or 707(b)(1) (generally, certain more-than-50-percent relationships, with specified attribution rules). For purposes of applying section 267(b)(2), such an entity would be treated as if it were an individual.

Effective Date

The provision would apply to sales or exchanges after June 8, 1997; except that it would not apply to a sale or exchange made pursuant to a written agreement which was binding on such date and at all times thereafter.

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

Present Law

Section 162(e) denies deductions as a trade or business expense for certain lobbying and political expenditures. Section 162(e)(3) provides a flow-through rule to disallow a deduction for a portion of membership dues or similar payments paid to a tax-exempt organization if the organization notifies the member under section 6033(e) that such portion of the membership dues is allocable to political or lobbying activities engaged in by the organization.

Under section 6033(e), tax-exempt organizations (other than charities described in section 501(c)(3)) that engage in lobbying or political campaign activities must disclose the amount of members' dues allocable to lobbying or political campaign expenditures to their members and to the Internal Revenue Service (IRS), except for certain in-house, de minimis expenses.¹¹⁰ If an organization fails to meet the disclosure requirement under section 6033(e), then the organization generally is subject to a so-called "proxy tax" equal to 35 percent of the amount of members' dues allowable to lobbying or political campaign expenditures. However, under section 6033(e)(3), organizations are exempt from the disclosure requirements and proxy tax if they can establish to the satisfaction of the Secretary of the Treasury that substantially all dues or other similar amounts received by the organization are not deductible without regard to whether or not the organization conducts lobbying or political campaign activities. In Rev. Proc. 95-35, the IRS announced that all tax-exempt organizations--other than (1) organizations described in section 501(c)(4) that are not veterans organizations, (2) agricultural and horticultural organizations described in section 501(c)(5), and (3) trade associations and other organizations described in section 501(c)(6)--are

¹¹⁰ Such disclosure is not required, however with respect to political expenditures if tax is imposed on the organization with respect to such expenditures under section 527(f) (see sec. 6033(e)(1)(B)(iii)).

deemed automatically to qualify for the section 6033(e)(3) exemption from the general disclosure requirements and proxy tax. Rev. Proc. 95-35 further provides that an organization described in section 501(c)(4) or an agricultural or horticultural organization described in section 501(c)(5) qualified for the section 6033(e)(3) exemption if the organization receives at least 90 percent of its dues from (a) members with annual dues of less than \$50 or (b) other tax-exempt organizations. Under Rev. Proc. 95-35, a trade association or other organization described in section 501(c)(6) qualifies for the section 6033(e)(3) exemption if the organization receives at least 90 percent of its dues from other tax-exempt organizations.¹¹¹

Description of Proposal

Section 6033(e)(3) would be amended to provide that the exemption from the general disclosure requirements and proxy tax of section 6033(e) would be available to a tax-exempt organization if more than 90 percent of the amount of aggregate annual dues (or similar payments) received by the organization are paid by (1) individuals or families whose annual dues (or similar amounts) are less than \$100,¹¹² or (2) tax-exempt entities. For purposes of the proposal, all organizations sharing a name, charter, historic affiliation, or similar characteristics and coordinating their activities would be treated as a single entity. As under present law, charities described in section 501(c)(3) would not be subject to the section 6033(e) disclosure requirements and proxy tax.

Effective Date

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

5. Repeal grandfather rule with respect to pension business of certain insurers

Present Law

Present law provides that an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. When this rule was enacted in 1986, certain treatment (described below) applied

¹¹¹ In addition, Rev. Proc. 95-35 provides that any organization may establish that it satisfies the section 6033(e)(3) exemption by (1) maintaining records establishing that 90 percent or more of the annual dues paid to the organization are not deductible without regard to whether or not the organization conducts lobbying or political campaign activities, and (2) notifying the IRS that it is described in section 6033(e)(3) on any Form 990 (i.e., annual information return) that it is required to file. Additionally, an organization may request a private letter ruling that the organization is eligible for the section 6033(e)(3) exemption.

¹¹² The \$100 amount would be indexed for inflation after December 31, 1997 (rounded to the nearest multiple of \$5).

to Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year.

The treatment applicable to such organizations, which became taxable organizations under the provision, is as follows. A special deduction applies with respect to health business equal to 25 percent of the claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the year. An exception is provided for such organizations from the application of the 20-percent reduction in the deduction for increases in unearned premiums that applies generally to property and casualty insurance companies. A fresh start was provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment was made under section 481 on account of an accounting method change. Such an organization was required to compute its ending 1986 loss reserves without artificial changes that would reduce 1987 income. Thus, any reserve weakening after August 16, 1986 was treated as occurring in the organization's first taxable year beginning after December 31, 1986. The basis of such an organization's assets was deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1986, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Grandfather rules were provided in the 1986 Act relating to the provision. It was provided that the provision does not apply to that portion of the business of the Teachers Insurance Annuity Association-College Retirement Equities Fund which is attributable to pension business, nor does the provision apply with respect to that portion of the business of Mutual of America which is attributable to pension business. Pension business means the administration of any plan described in section 401(a) of the Code which includes a trust exempt from tax under section 501(a), and plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b) of the Code, any individual retirement plan described in section 408 of the Code, and any eligible deferred compensation plan to which section 457(a) of the Code applies.

Description of Proposal

The proposal would repeal the grandfather rules applicable to that portion of the business of the Teachers Insurance Annuity Association-College Retirement Equities Fund which is attributable to pension business and to that portion of the business of Mutual of America which is attributable to pension business. The Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America would be treated for Federal tax purposes as stock life insurance companies. A fresh start would be provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment would be made under section 481 on account of an accounting method change. The Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of

America would be required to compute ending 1997 loss reserves without artificial changes that would reduce 1998 income. Thus, any reserve weakening after June 8, 1997, would be treated as occurring in the organization's first taxable year beginning after December 31, 1997. The basis of assets of Teachers Insurance Annuity Association and College Retirement Equities Fund and Mutual of America would be deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1997, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Effective Date

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

G. Other Revenue-Increase Provisions

1. Phase out suspense accounts for certain large farm corporations

Present Law

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

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

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

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

Description of Proposal

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

In addition, any taxpayer with an existing suspense account would be required to restore the account into income ratably over a 20-year period beginning in the first taxable year beginning after June 8, 1997, subject to the present-law requirements to restore such accounts more rapidly. In no event would the amount required to be restored to income for a taxable year pursuant to the 20-year spread period exceed the net operating loss of the corporation for the year or 50 percent of the net income of the taxpayer for the year (determined without regard to the amount restored to income under the proposal). Any reduction in the amount required to be restored to income would be taken into account ratably over the remaining years in the 20-year period or, if applicable, after the end of the 20-year period.

Effective Date

The proposal would be effective for taxable years ending after June 8, 1997.

2. Modify net operating loss carryback and carryforward rules

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 15 years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. Special rules apply to real estate investment trusts ("REITs") (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

Description of Proposal

The proposal would limit the NOL carryback period to two years 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. In addition, the proposal would not apply to NOLs arising from casualty losses of individual taxpayers.

Effective Date

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

3. Expand the limitations on deductibility of premiums and interest with respect to life insurance, endowment and annuity contracts

Present Law

Exclusion of inside buildup and amounts received by reason of death

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").¹¹³ 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)).

Premium deduction limitation

No deduction is permitted for premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy (sec. 264(a)(1)).

Under this premium deduction disallowance rule, if a taxpayer has an insurable interest in an individual who is not an employee or officer of, or person financially interested in, the taxpayer, then the premium deduction limitation does not apply. For example, if a mortgage lender can under applicable State law insure the life of a mortgage borrower, the lender may be able to deduct premiums on such a contract, if no other deduction disallowance rule or principle of tax law were to limit the deduction. The premiums may continue to be deductible even after the individual's mortgage loan is transferred by the taxpayer to another lender or to a mortgage pool, for example.

¹¹³ 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 10 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 7 annual level premiums (sec. 7702A). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid of the death of the insured (sec. 101(g)).

Interest deduction disallowance with respect to life insurance

Present law provides generally that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance contracts or annuity or endowment contracts owned by the taxpayer covering any individual who is or has been (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer (the "COLI" rules).

This interest deduction disallowance rule generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986; rather, an interest deduction limit based on Moody's Corporate Bond Yield Average--Monthly Average Corporates applies in the case of such contracts.¹¹⁴

An exception to this interest disallowance rule is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) 5 individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 20 individuals. For determining who is a 20-percent owner, all members of a controlled group are treated as one taxpayer. Interest paid or accrued on debt with respect to a contract covering a key person is deductible only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average - Monthly Average Corporates for each month beginning after December 31, 1995, that interest is paid or accrued.

The foregoing interest deduction limitation was added in 1996 to existing statutory interest deduction limitations with respect to life insurance and similar contracts.¹¹⁵

¹¹⁴ Phase-in rules apply generally with respect to otherwise deductible interest paid or accrued after December 31, 1995, and before January 1, 1999, in the case of debt incurred before January 1, 1996. In addition, transition rules apply.

¹¹⁵ Since 1942, a limitation has applied to the deductibility of interest with respect to single premium contracts (sec. 264(a)(2)). For this purpose, a contract is treated as a single premium contract if (1) substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or (2) an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. Further, under a limitation added in 1964, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment, or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (sec. 264(a)(3)). 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)).

Interest deduction limitation with respect to tax-exempt interest income

Present law provides that no deduction is allowed for interest on debt incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax (sec. 265(a)(2)). In addition, in the case a financial institution, a proration rule provides that no deduction is allowed for that portion of the taxpayer's interest that is allocable to tax-exempt interest (sec. 265(b)). The portion of the interest deduction that is disallowed under this rule generally is the portion determined by the ratio of the taxpayer's (1) average adjusted bases of tax-exempt obligations acquired after August 7, 1986, to (2) the average adjusted bases for all of the taxpayer's assets (sec. 265(b)(2)).¹¹⁶

Description of Proposal

Expansion of premium deduction limitation to individuals in whom taxpayer has an insurable interest

Under the proposal, the present-law premium deduction limitation would be modified to provide that no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract covering the life of any individual, when the taxpayer is directly or indirectly a beneficiary under the contract.

Expansion of interest disallowance to individuals in whom taxpayer has insurable interest

Under the proposal, no deduction would be allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment, or annuity contract covering the life of any individual. Thus, the proposal would limit interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest under applicable State law, except as otherwise provided under present law with respect to key persons and pre-1986 contracts.

Pro rata disallowance of interest on debt to fund life insurance

In the case of a taxpayer other than a natural person, no deduction would be allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract. Interest expense would be so allocable based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, to (2) the average adjusted bases for all assets of the taxpayer. In determining unborrowed policy cash surrender values, life insurance policies and annuity and endowment contracts

¹¹⁶ Special rules apply for certain tax-exempt obligations of small issuers (sec. 265(b)(3)).

covering the life of an employee, officer or director of the taxpayer would not be taken into account.

If a trade or business (other than a sole proprietorship or a trade or business of performing services as an employee) is directly or indirectly the beneficiary under any policy or contract, then the policy or contract would be treated as held by the trade or business. For this purpose, the unborrowed cash value would not exceed the amount of the benefit payable to the trade or business. In the case of a partnership or S corporation, the proposal would apply at the partnership or corporate level.

If interest expense is disallowed under other rules limiting interest deductions with respect to life insurance policies or endowment or annuity contracts or tax-exempt interest, then the disallowed interest expense would not be taken into account under the proposal, and the average adjusted bases of assets would be reduced by the amount of debt, interest on which is so disallowed. The proposal would be applied before present-law rules relating to capitalization of certain expenses where the taxpayer produces property.

An aggregation rule would be provided, treating related persons as one for purposes of the proposal.

As provided in regulations, the issuer or policyholder of the life insurance policy or endowment or annuity contract would be required to report the amount of the amount of the unborrowed cash value in order to carry out the proposal.

The proposal would not apply to any insurance company subject to tax under subchapter L of the Code. Rather, the rules limiting such companies' deductions attributable to tax-exempt interest and deductible dividends received would be modified to take into account unborrowed policy cash values.

Effective Date

The proposals would apply with respect to contracts issued after June 8, 1997. For this purpose, a material change in the contract would be treated as the issuance of a new contract. An increase in the death benefit under a contract after that date would cause the contract to be treated as issued after that date. In the case of a group contract, the contract would be treated as issued only with respect to those individuals covered before June 9, 1997.

4. Allocation of basis of properties distributed to a partner by a partnership

Present Law

In general

The partnership provisions of present law generally permit partners to receive distributions of partnership property without recognition of gain or loss (sec. 731).¹¹⁷ Rules are provided for determining the basis of the distributed property in the hands of the distributee, and for allocating basis among multiple properties distributed, as well as for determining adjustments to the distributee partner's basis in its partnership interest. Property distributions are tax-free to a partnership. Adjustments to the basis of the partnership's remaining undistributed assets are not required unless the partnership has made an election that requires basis adjustments both upon partnership distributions and upon transfers of partnership interests (sec. 754).

Partner's basis in distributed properties and partnership interest

Present law provides two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (sec. 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (sec. 733).

¹¹⁷ Exceptions to this nonrecognition rule apply: (1) when money (and the fair market value of marketable securities) received exceeds a partner's adjusted basis in the partnership (sec. 731(a)(1)); (2) when only money, inventory and unrealized receivables are received in liquidation of a partner's interest and loss is realized (sec. 731(a)(2)); (3) to certain disproportionate distributions involving inventory and unrealized receivables (sec. 751(b)); and (4) to certain distributions relating to contributed property (secs. 704(c) and 737). In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner (sec. 707).

Allocating basis among distributed properties

In the event that multiple properties are distributed by a partnership, present law provides allocation rules for determining their bases in the distributee partner's hands. An allocation rule is needed when the substituted basis rule for liquidating distributions applies, in order to assign a portion of the partner's basis in its partnership interest to each distributed asset. An allocation rule is also needed in a non-liquidating distribution of multiple assets when the total carryover basis would exceed the partner's basis in its partnership interest, so a portion of the partner's basis in its partnership interest is assigned to each distributed asset.

Present law provides for allocation in proportion to the partnership's adjusted basis. The rule allocates basis first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the allocated basis is less than partnership basis, then in proportion to the partnership's basis), and then among other properties in proportion to their adjusted bases to the partnership (sec. 732(c)).¹¹⁸ Under this allocation rule, in the case of a liquidating distribution, the distributee partner can have a basis in the distributed property that exceeds that partnership's basis in the property.

Description of Proposal

The proposal would modify the basis allocation rules for distributee partners. It would allocate a distributee partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property (as under present law). Under the proposal, any remaining basis would be allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, would be allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. If the remaining basis adjustment is a decrease, it would be allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made).

¹¹⁸ A special rule allows a partner that acquired a partnership interest by transfer within two years of a distribution to elect to allocate the basis of property received in the distribution as if the partnership had a section 754 election in effect (sec. 732(d)). The special rule also allows the Service to require such an allocation where the value at the time of transfer of the property received exceeds 110 percent of its adjusted basis to the partnership (sec. 732(d)). Treas. Reg. sec. 1.732-1(d)(4) generally requires the application of section 732(d) where the allocation of basis under section 732(c) upon a liquidation of the partner's interest would have resulted in a shift of basis from non-depreciable property to depreciable property.

Effective Date

The proposal would apply to partnership distributions after the date of enactment.

5. Treatment of inventory items of a partnership

Present Law

Under present law, upon the sale or exchange of a partnership interest, any amount received that is attributable to unrealized receivables, or to inventory that has substantially appreciated, is treated as an amount realized from the sale or exchange of property that is not a capital asset (sec. 751(a)).

Present law provides a similar rule to the extent that a distribution is treated as a sale or exchange of a partnership interest. A distribution by a partnership in which a partner receives substantially appreciated inventory or unrealized receivables in exchange for its interest in certain other partnership property (or receives certain other property in exchange for its interest in substantially appreciated inventory or unrealized receivables) is treated as a taxable sale or exchange of property, rather than as a nontaxable distribution (sec. 751(b)).

For purposes of these rules, inventory of a partnership generally is treated as substantially appreciated if the fair market value of the inventory exceeds 120 percent of adjusted basis of the inventory to the partnership (sec. 751(d)(1)(A)). In applying this rule, inventory property is excluded from the calculation if a principal purpose for acquiring the inventory property was to avoid the rules relating to inventory (sec. 751(d)(1)(B)).

Description of Proposal

The proposal would eliminate the requirement that inventory be substantially appreciated in order to give rise to ordinary income under the rules relating to sales and exchanges of

partnership interests and certain partnership distributions.¹¹⁹ This would conform the treatment of inventory to the treatment of unrealized receivables under these rules.

Effective Date

The proposal would be effective for sales, exchanges, and distributions after the date of enactment.

6. Treatment of appreciated property contributed to a partnership

Present Law

Under present law, if a partner contributes appreciated property to a partnership, no gain is recognized to the contributing partner at the time of the contribution. The contributing partner's basis in its partnership interest is increased by the basis of the contributed property at the time of the contribution. The pre-contribution gain is reflected in the difference between the partner's capital account and its basis in its partnership interest ("book/tax differential").

If the property is subsequently distributed to another partner within 5 years of the contribution, the contributing partner generally recognizes gain as if the property had been sold for its fair market value at the time of the distribution (sec. 704(c)(1)(B)). Similarly, the contributing partner generally includes pre-contribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds its adjusted basis in its partnership interest, if the distribution by the partnership is made within 5 years after the contribution of the appreciated property (sec. 737).

Description of Proposal

The proposal would extend the 5-year limit under present law. Thus, a partner that contributes appreciated property to a partnership would be subject to tax on the pre-contribution gain in the event of a distribution of the appreciated property to another partner, or a distribution of

¹¹⁹ The ALI study on partnership rules referred to the substantial appreciation requirement as subject to manipulation and tax planning (American Law Institute, Federal Income Tax Project: Subchapter K: Proposals on the Taxation of Partners, supra, at 26. In 1993 the definition of substantially appreciated inventory was modified, and the present-law test relating to a principal purpose of avoidance was added (Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, sec. 13206(e)(1)). Nevertheless, the substantial appreciation requirement is still criticized as largely ineffective on at least two grounds (McKee, Nelson and Whitmire, Federal Taxation of Partners and Partnerships, supra, sec. 16.04[2]: (1) that it applies only to inventory items and not unrealized receivables and so does not insulate most partnerships from section 751; and (2) it may operate to exclude large amounts of ordinary income from section 751 if the partnership's profit margin is below 20 percent.

other property to the contributing partner, if such a distribution occurs within 10 years after the partner's contribution of the appreciated property.

Effective Date

The proposal would be effective for property contributed to a partnership after June 8, 1997.

7. Eligibility for income forecast method

Present Law

In general

A taxpayer generally recovers the cost of property used in a trade or business through depreciation or amortization deductions over time. Tangible property generally is depreciated under the modified Accelerated Cost Recovery System ("MACRS") of section 168, which applies specific recovery periods 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 any motion picture film, video tape, or sound recording or to other any 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. 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 not acquired in transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the "income forecast" method.

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.¹²⁰ Most recently, the income forecast method has been held applicable to consumer durable property subject to short-term "rent-to-own" leases.¹²¹

Description of Proposal

The proposal would clarify the types of property to which the income forecast method may be applied. Under the proposal, the income forecast method would be applicable to motion picture films, television films and taped shows, books, patents, master sound recordings, copyrights, and other such property as designated by the Secretary of the Treasury. The income forecast method would not be applicable to property to which section 197 applies.

In addition, consumer durables subject to rent-to-own contracts would be provided a three-year recovery period and a 4- year class life for MACRS purposes (and would not be eligible for the income forecast method). Such property generally is described in Rev. Proc. 95-38, 1995-34 I.R.B. 25.

Effective Date

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

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

Present Law

Gross income for purposes of the Internal Revenue Code generally includes all income from whatever source derived, including rents. The Code (sec. 280A(g)) provides a *de minimis* exception to this rule where a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year.

¹²⁰ See, e.g., Rev. Rul. 60-358, 1960-2 C.B. 68; Rev. Rul. 64-273, 1964-2 C.B. 62; Rev. Rul. 79-285, 1979-2 C.B. 91; and Rev. Rul. 89-62, 1989-1 C.B. 78. Conversely, the courts have held that certain tangible personal property was not of a character to which the income forecast method was applicable.

¹²¹ See, ABC Rentals of San Antonio v. Comm., No. 95-9008 (10th Cir. 9/27/96), the Tenth Circuit decision reversed the holding of ABC Rentals of San Antonio v. Comm., 68 TCM 1362 (1994) (consumer durable property subject to short-term, "rent-to-own" leases not eligible). For decisions supporting the Tax Court decision, see, El Charro TV Rental v. Comm., No. 95-60301 (5th Cir., May 16, 1995) (rent-to-own property not eligible) and Carland, Inc. v. Comm., 90 T.C. 505 (1988), *aff'd* on this issue, 909 F.2d 1101 (8th Cir., 1990) (railroad rolling stock subject to a lease not eligible).

In this case, the income from such rental is not included in gross income and no deductions arising from such rental use are allowed as a deduction.

Description of Proposal

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

Effective Date

The proposal would apply to taxable years beginning after December 31, 1997.

9. Modify the exception to the related party rule of section 1033 for individuals to only provide an exception for de minimis amounts

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 period of time. Pursuant to a provision of Public Law 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. A person is treated as related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1). An exception to this related party rule provides that a taxpayer could purchase replacement property or stock from a related person and defer gain under section 1033 to the extent the related person acquired the replacement property or stock from an unrelated person within the period prescribed under section 1033.

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 partnerships (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 applies to involuntary conversions occurring after June 8, 1997.

10. Repeal of exception for certain sales by manufacturers to dealers

Present Law

In general, the installment sales method of accounting may not be used by dealers in personal property. Present law provides an exception which permits the use of the installment method for installment obligations arising from the sale of tangible personal property by a manufacturer of the property (or an affiliate of the manufacturer) to a dealer,¹²² but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine month period following the sale to the dealer, and certain other conditions are met. In order to meet the other conditions, the aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50 percent of the total sales to dealers that gave rise to such receivables (the "fifty percent test") in both the taxable year and the preceding taxable year, except that, if the taxpayer met all of the requirements for the exception in the preceding taxable year, the taxpayer would not be treated as failing to meet the fifty percent test before the second consecutive year in which the taxpayer did not actually meet the test. For purposes of applying the fifty percent test, the aggregate face amount of the taxpayer's receivables is computed using the weighted average of the taxpayer's receivables outstanding at the end of each month during the taxpayer's taxable year. In addition, these requirements must be met by the taxpayer in its first taxable year beginning after October 22, 1986, except that obligations issued before that date are treated as meeting the applicable requirements if such obligations were conformed to the requirements of the provision within 60 days of that date.

Description of Proposal

The proposal would repeal the exception that permits the use of the installment method of accounting for certain sales by manufacturers to dealers.

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.

¹²² I.e., the sale of the property must be intended to be for resale or leasing by the dealer.

XI. FOREIGN TAX PROVISIONS

A. General Provisions

1. Eligibility of licenses of computer software for foreign sales corporation benefits

Present law

Under special tax provisions that provide an export incentive, a portion of the foreign trade income of an eligible foreign sales corporation ("FSC") is exempt from Federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. The term "foreign trading gross receipts" includes the gross receipts of a FSC from the sale, lease, or rental of export property and from services related and subsidiary to such sales, leases, or rentals.

For purposes of the FSC rules, export property is defined as property (1) which is manufactured, produced, grown, or extracted in the United States by a person other than a FSC; (2) which is held primarily for sale, lease, or rental in the ordinary conduct of a trade or business by or to a FSC for direct use, consumption, or disposition outside the United States; and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. Intangible property generally is excluded from the definition of export property for purposes of the FSC rules; this exclusion applies to copyrights other than films, tapes, records, or similar reproductions for commercial or home use. The temporary Treasury regulations provide that a license of a master recording tape for reproduction outside the United States is not excluded from the definition of export property (Treas. Reg. sec. 1.927(a)-1T(f)(3)). The statutory exclusion for intangible property does not contain any specific reference to computer software. However, the temporary Treasury regulations provide that a copyright on computer software does not constitute export property, and that standardized, mass marketed computer software constitutes export property if such software is not accompanied by a right to reproduce for external use (Treas. Reg. sec. 1.927(a)-1T(f)(3)).

Description of Proposal

The proposal would provide that computer software licensed for reproduction abroad would not be excluded from the definition of export property for purposes of the FSC provisions. Accordingly, computer software that is exported with a right to reproduce would be eligible for the benefits of the FSC provisions. In light of the rapid innovations in the computer and software industries, it would be intended that the term "computer software" be construed broadly to accommodate technological changes in the products produced by both industries. No inference would be intended regarding the qualification as export property of computer software licensed for reproduction abroad under present law.

Effective Date

The proposal generally would apply to computer software licenses granted after December 31, 1997. However, in the case of licenses granted during 1998, the proposal would apply to only one-third of the gross receipts with respect to such licenses. In the case of licenses granted during 1999, the proposal would apply to only two-thirds of the gross receipts with respect to such licenses.

2. Increase dollar limitation on section 911 exclusion

Present Law

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on such income by that foreign country.

U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs. In order to qualify for these exclusions, a U.S. citizen must be either (1) a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year or (2) present overseas for 330 days out of any 12 consecutive month period. In addition, the taxpayer must have his or her tax home in a foreign country.

The exclusion for foreign earned income generally applies to income earned from sources outside the United States as compensation for personal services actually rendered by the taxpayer. The maximum exclusion for foreign earned income for a taxable year is \$70,000.

The exclusion for housing costs applies to reasonable expenses, other than deductible interest and taxes, paid or incurred by or on behalf of the taxpayer for housing for the taxpayer and his or her spouse and dependents in a foreign country. The exclusion amount for housing costs for a taxable year is equal to the excess of such housing costs for the taxable year over an amount computed pursuant to a specified formula.

The combined earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income.

Description of Proposal

Under the proposal, the \$70,000 limitation on the exclusion for foreign earned income would be increased to \$80,000, in increments of \$2,000 each year beginning in 1998. Under the proposal, the limitation on the exclusion for foreign earned income then would be indexed for inflation beginning in 2008.

Effective Date

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

3. Simplify foreign tax credit limitation for individuals

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments. Taxable income of this type ordinarily is includible in the single foreign tax credit limitation category for as passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in one of several other separate limitation categories (e.g., high withholding tax interest income or general limitation income). For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Description of Proposal

The proposal would allow individuals with no more than \$300 (\$600 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than passive income, an exemption from the foreign tax credit limitation rules. (It is intended that an individual electing this exemption would not be required to file Form 1116 in order to obtain the benefit of the foreign tax credit.) An individual making this election would not be entitled to any carryover of excess foreign taxes to or from a taxable year to which the election applies.

For purposes of this election, passive income generally would be defined to include all types of income that is foreign personal holding company income under the subpart F rules, plus income inclusions from foreign personal holding companies and passive foreign investment companies, provided that the income is shown on a payee statement furnished to the individual. For purposes of this election, creditable foreign taxes would include only foreign taxes that are shown on a payee statement furnished to the individual.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1997.

4. Simplify translation of foreign taxes

Present Law

Translation of foreign taxes

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession. This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation.

Redetermination of foreign taxes

For taxpayers that utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual. If a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination of foreign taxes arises. A foreign tax redetermination may occur in the case of a refund of foreign taxes. A foreign tax redetermination also may arise because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. In addition, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment.

As a general matter, a redetermination of foreign tax paid or accrued directly by a U.S. person requires notification of the Internal Revenue Service and a redetermination of U.S. tax liability for the taxable year for which the foreign tax was claimed as a credit. Regulations provide exceptions to this rule for de minimis cases. In the case of a redetermination of foreign taxes that qualify for the indirect (or "deemed-paid") foreign tax credit under sections 902 and 960, regulations generally require taxpayers to make appropriate adjustments to the payor foreign corporation's pools of earnings and profits and foreign taxes.

Description of Proposal

Translation of foreign taxes

Translation of certain accrued foreign taxes

With respect to taxpayers who take foreign income taxes into account when accrued, the proposal generally would provide for foreign taxes to be translated at the average exchange rate for the taxable year to which such taxes relate. This rule would not apply (1) to any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate, (2)

with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to tax payments that are denominated in an inflationary currency (as defined by regulations).

Translation of all other foreign taxes

Under the proposal, foreign taxes not eligible for application of the preceding rules generally would be translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The proposal would provide the Secretary of the Treasury with authority to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.

Redetermination of foreign taxes

Under the proposal, a redetermination would be required if: (1) accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, (2) accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, or (3) any tax paid is refunded in whole or in part. Thus, for example, the proposal provides that if at the close of the second taxable year after the taxable year to which an accrued tax relates, any portion of the tax so accrued has not yet been paid, a foreign tax redetermination under section 905(c) would be required for the amount representing the unpaid portion of that accrued tax. In other words, the previous accrual of any tax that is unpaid as of that date would be denied. In cases where a redetermination is required, as under present law, the proposal specifies that the taxpayer must notify the Secretary, who would redetermine the amount of the tax for the year or years affected.

The proposal provides that in the case of accrued taxes not paid within the date two years after the close of the taxable year to which such taxes relate, except to the extent provided in regulations, any such taxes if subsequently paid would be taken into account for the taxable year to which such taxes relate. These taxes would be translated into U.S. dollar amounts using the exchange rates in effect for the period during which such taxes are paid.

For example, assume that in year 1 a taxpayer accrues 1,000 units of foreign tax that relate to year 1 and that the currency involved is not inflationary. Further assume that as of the end of year 1 the tax is unpaid. In this case, the proposal would provide that the taxpayer would translate 1,000 units of accrued foreign tax into U.S. dollars at the average exchange rate for year 1. If the 1,000 units of tax were paid by the taxpayer in either year 2 or year 3, no redetermination of foreign tax would be required. If any portion of the tax so accrued remained unpaid as of the end of year 3, however, the taxpayer would be required to redetermine its foreign tax accrued in year 1 to eliminate the accrued but unpaid tax, thereby reducing its foreign tax credit for such year. If the taxpayer paid the disallowed taxes in year 4 the taxpayer would again would redetermine its foreign taxes (and foreign tax credit) for year 1, but the taxes paid in year 4 would be translated into U.S. dollars at the exchange rate for year 4.

Effective Date

The proposal generally would be effective for foreign taxes paid (in the case of taxpayers using the cash basis for determining the foreign tax credit) or accrued (in the case of taxpayers using the accrual basis for determining the foreign tax credit) in taxable years beginning after December 31, 1997. The proposal's changes to the foreign tax redetermination rules would apply to foreign taxes which relate to taxable years beginning after December 31, 1997.

5. Election to use simplified foreign tax credit limitation for alternative minimum tax purposes

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source income and items of U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, after allocating and apportioning deductions for regular tax foreign tax credit limitation purposes, additional allocations and apportionments generally must be performed in order to compute the AMT foreign tax credit limitation.

Description of Proposal

The proposal would permit taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source alternative minimum taxable income to entire alternative minimum taxable income. Under this election, foreign source regular taxable income would be used, however, only to the extent it does not exceed entire alternative minimum taxable income. In the event that foreign source regular taxable income does exceed entire alternative minimum taxable income, and the taxpayer has income in more than one foreign tax credit limitation category, it is intended that the foreign source taxable income in each such category generally would be reduced by a pro rata portion of that excess.

The election would be available only in the first taxable year beginning after December 31, 1997, for which the taxpayer claims an AMT foreign tax credit. It is intended that a taxpayer would be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election, once made, would apply to all subsequent taxable years, and could be revoked only with the consent of the Secretary of the Treasury.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1997.

6. Simplify treatment of personal transactions in foreign currency

Present Law

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

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

Prior to the Tax Reform Act of 1986 ("1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the IRS. Additional rules of limited application were provided by Treasury regulations. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The 1986 Act provided a comprehensive set of rules for the U.S. tax treatment of transactions involving foreign currencies.

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

Description of Proposal

Under the proposal, if an individual acquires foreign currency and disposes of it in a personal transaction and the exchange rate changes between the acquisition and disposition of such currency, nonrecognition treatment would apply to any resulting exchange gain, provided that such gain does not exceed \$200. The proposal would not change the treatment of resulting exchange losses. It is understood that under other Code provisions, such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The proposal would apply to taxable years beginning after December 31, 1997.

7. Simplify foreign tax credit limitation for dividends from 10/50 companies

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. 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. Separate limitations are applied to specific categories of income.

Special foreign tax credit limitation rules apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company"). Dividends received by the taxpayer from each 10/50 company are subject to a separate foreign tax credit limitation.

Description of Proposal

Under the proposal, a single foreign tax credit limitation generally would apply to dividends received by the taxpayer from all 10/50 companies. However, separate foreign tax credit limitations would continue to apply to dividends received by the taxpayer from each 10/50 company that qualifies as a passive foreign investment company. Regulatory authority would be granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Effective Date

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

B. General Provisions Affecting Treatment of Controlled Foreign Corporations

Present Law

If an upper-tier controlled foreign corporation ("CFC") sells stock of a lower-tier CFC, the gain generally is included in the income of U.S. 10-percent shareholders as subpart F income and such U.S. shareholder's basis in the stock of the first-tier CFC is increased to account for the inclusion. The inclusion is not characterized for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier CFC; instead it generally is characterized as passive income.

For purposes of the foreign tax credit limitations applicable to so-called 10/50 companies, a CFC is not treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC and, except as provided in regulations, the recipient of the distribution was a U.S. 10-percent shareholder in such corporation.

If subpart F income of a lower-tier CFC is included in the gross income of a U.S. 10-percent shareholder, no provision of present law allows adjustment of the basis of the upper-tier CFC's stock in the lower-tier CFC.

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. 10-percent shareholders of the corporation on the last day, in that year, on which the corporation is a CFC. In the case of a U.S. 10-percent shareholder who acquired stock in a CFC during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquiror with respect to that stock.

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the CFC. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

A U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. A U.S. corporation also may be deemed to have paid taxes paid by a second- or third-tier foreign corporation if certain conditions are satisfied.

Description of Proposal

Lower-tier CFCs

Characterization of gain on stock disposition

Under the proposal, if a CFC is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain would be treated as a dividend to the same extent that it would have been so treated under section 1248 if the CFC were a U.S. person. This proposal, however, would not affect the determination of whether the corporation whose stock is sold or exchanged is a CFC.

Thus, for example, if a U.S. corporation owns 100 percent of the stock of a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, then under the proposal, any gain of the first corporation upon a sale or exchange of stock of the second corporation would be treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a CFC with respect to the U.S. shareholder.

Gain on disposition of stock in a related corporation created or organized under the laws of, and having a substantial part of its assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the proposal, would not be excluded from foreign personal holding company income under the same-country exception that applies to actual dividends.

Under the proposal, for purposes of this rule, a CFC is treated as having sold or exchanged stock if, under any provision of subtitle A of the Code, the CFC would be treated as having gain from the sale or exchange of such stock. Thus, for example, if a CFC distributes to its shareholder stock in a foreign corporation, and the distribution results in gain being recognized by the CFC under section 311(b) as if the stock were sold to the shareholder for fair market value, the proposal would make clear that, for purposes of this rule, the CFC is treated as having sold or exchanged the stock.

The proposal also would repeal a provision added to the Code by the Technical and Miscellaneous Revenue Act of 1988 that, except as provided by regulations, requires a recipient of a distribution from a CFC to have been a U.S. 10-percent shareholder of that CFC for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a 10/50 company. Thus, under the proposal, a CFC would not be treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC, whether or not the recipient of the distribution was a U.S. 10-percent shareholder of the corporation when the earnings and profits giving rise to the distribution were generated.

Adjustments to basis of stock

Under the proposal, when a lower-tier CFC earns subpart F income, and stock in that corporation is later disposed of by an upper-tier CFC, the resulting income inclusion of the U.S. 10-percent shareholders would, under regulations, be adjusted to account for previous inclusions, in a manner similar to the adjustments currently provided to the basis of stock in a first-tier CFC. Thus, just as the basis of a U.S. 10-percent shareholder in a first-tier CFC rises when subpart F income is earned and falls when previously taxed income is distributed, so as to avoid double taxation of the income on a later disposition of the stock of that company, the subpart F income from gain on the disposition of a lower-tier CFC generally would be reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier CFC.

For example, assume that a U.S. person is the owner of all of the stock of a first-tier CFC which, in turn, is the sole shareholder of a second-tier CFC. In year 1, the second-tier CFC earns \$100 of subpart F income which is included in the U.S. person's gross income for that year. In year 2, the first-tier CFC disposes of the second-tier CFC's stock and recognizes \$300 of income with respect to the disposition. All of that income would constitute subpart F foreign personal holding company income. Under the proposal, the Secretary would be granted regulatory authority to reduce the U.S. person's year 2 subpart F inclusion by \$100--the amount of year 1 subpart F income of the second-tier CFC that was included, in that year, in the U.S. person's gross income. Such an adjustment would, in effect, allow for a step-up in the basis of the stock of the second-tier CFC to the extent of its subpart F income previously included in the U.S. person's gross income.

Subpart F inclusions in year of acquisition

If a U.S. 10-percent shareholder acquires the stock of a CFC from another U.S. 10-percent shareholder during a taxable year of the CFC in which it earns subpart F income, the proposal would reduce the acquirer's subpart F income inclusion for that year by a portion of the amount of the dividend deemed (under sec. 1248) to be received by the transferor. The portion by which the inclusion would be reduced (as is currently the case if a dividend was paid to the previous owner of the stock) would not exceed the lesser of the amount of dividends with respect to such stock deemed received (under sec. 1248) by other persons during the year or the amount determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Treatment of U.S. income earned by a CFC

Under the proposal, an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a CFC would not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income. For example, assume a CFC earns income of a type that generally would be subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S. branch profits tax under a provision of an applicable U.S. income tax treaty. The proposal would provide that,

notwithstanding the treaty's effect on the branch tax, the income is not treated as subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

Extension of indirect foreign tax credit

The proposal would extend the application of the indirect foreign tax credit (secs. 902 and 960) to taxes paid or accrued by certain fourth-, fifth-, and sixth-tier foreign corporations. In general, three requirements would be required to be satisfied by a foreign company at any of these tiers to qualify for the credit. First, the company must be a CFC. Second, the U.S. corporation claiming the credit under section 902(a) must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the foreign company. Third, the product of the percentage ownership of voting stock at each level from the U.S. corporation down must equal at least 5 percent. The proposal would limit the application of the indirect foreign tax credit below the third tier to taxes paid or incurred in taxable years during which the payor is a CFC. All foreign taxes paid below the sixth tier of foreign corporations would remain ineligible for the indirect foreign tax credit.

Effective Dates

Lower-tier CFCs.--The provision of the proposal that would treat gains on dispositions of stock in lower-tier CFCs as dividends under section 1248 principles would apply to gains recognized on transactions occurring after the date of enactment.

The provision that would expand look-through treatment, for foreign tax credit limitation purposes, of dividends from CFCs, would be effective for distributions after the date of enactment.

The provision that would provide for regulatory adjustments to U.S. shareholder inclusions, with respect to gains of CFCs from dispositions of stock in lower-tier CFCs would be effective for determining inclusions for taxable years of U.S. shareholders beginning after December 31, 1997. Thus, the proposal would permit regulatory adjustments to an inclusion occurring after the effective date to account for income that was previously taxed under the subpart F provisions either prior to or subsequent to the effective date.

Subpart F inclusions in year of acquisition.--The provision that would permit dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year would be effective with respect to dispositions occurring after the date of enactment.

Treatment of U.S. source income earned by a CFC.--The provision concerning the effect of treaty exemptions from, or reductions of, the branch profits tax on the determination of subpart F income would be effective for taxable years beginning after December 31, 1986.

Extension of indirect foreign tax credit.--The provision that would extend application of the indirect foreign tax credit to certain CFCs below the third tier would be effective for foreign taxes

paid or incurred by CFCs for taxable years of such corporations beginning after the date of enactment.

In the case of any chain of foreign corporations, the taxes of which would be eligible for the indirect foreign tax credit, under present law or under the proposal, but for the denial of indirect credits below the third or sixth tier, as the case may be, no liquidation, reorganization, or similar transaction in a taxable year beginning after the date of enactment would have the effect of permitting taxes to be taken into account under the indirect foreign tax credit provisions of the Code which could not have been taken into account under those provisions but for such transaction.

C. Modification of Passive Foreign Investment Company Provisions to Eliminate Overlap with Subpart F and to Allow Mark-to-Market Election

Present Law

Overview

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. A foreign corporation generally is not subject to U.S. tax on its income from operations outside the United States.

Income of a foreign corporation generally is taxed by the United States when it is repatriated to the United States through payment to the corporation's U.S. stockholders, subject to a foreign tax credit. However, a variety of regimes imposing current U.S. tax on income earned through a foreign corporation have been reflected in the Code. Today the principal anti-deferral regimes set forth in the Code are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1297). Additional anti-deferral regimes set forth in the Code are the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and the foreign investment company and electing foreign investment company rules (secs. 1246-1247). The anti-deferral regimes included in the Code overlap such that a given taxpayer may be subject to multiple sets of anti-deferral rules.

Controlled foreign corporations

A controlled foreign corporation (CFC) is defined in the Code generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also all stock owned indirectly or constructively (sec. 958).

Certain income of a CFC (sometimes referred to as "subpart F income") is subject to current U.S. tax under the Code's subpart F provisions. Subpart F income typically is income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. When a CFC earns subpart F income, the United States generally taxes the corporation's U.S. 10-percent shareholders currently on their pro rata shares of the subpart F income. In effect, the Code treats those U.S. shareholders as having received a current distribution out of the subpart F income. Such shareholders also are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in U.S. property. The foreign tax credit may reduce the U.S. tax on these amounts.

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies (PFICs). A PFIC is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income (sec. 1296(a)). Two alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), under which the U.S. shareholders pay tax on income realized from a PFIC and an interest charge that is attributable to the value of deferral.

Overlap between subpart F and the PFIC provisions

A foreign corporation that is a CFC is also a PFIC if it meets the passive income test or the passive asset test described above. In such a case, the 10-percent U.S. shareholders are subject both to the subpart F provisions (which require current inclusion of certain earnings of the corporation) and to the PFIC provisions (which impose an interest charge on amounts distributed from the corporation and gains recognized upon the disposition of the corporation's stock, unless an election is made to include currently all of the corporation's earnings).

Description of Proposal

Elimination of overlap between subpart F and the PFIC provisions

In the case of a PFIC that is also a CFC, the proposal generally would treat the corporation as not a PFIC with respect to certain 10-percent shareholders. This rule would apply if the corporation is a CFC (within the meaning of section 957(a)) and the shareholder is a U.S. shareholder (within the meaning of section 951(b)) of such corporation (i.e., if the shareholder is subject to the current inclusion rules of subpart F with respect to such corporation). Moreover, the rule would apply for that portion of the shareholder's holding period with respect to the corporation's stock which is after December 31, 1997 and during which the corporation is a CFC and the shareholder is a U.S. shareholder. Accordingly, a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally would not be subject also to the PFIC provisions with respect to the same stock. As under present law, the PFIC provisions would continue to apply in the case of a PFIC that is also a CFC to shareholders that are not subject to subpart F (i.e., to shareholders that are U.S. persons and that own (directly, indirectly, or constructively) less than 10 percent of the corporation's stock by vote).

If a shareholder of a PFIC is subject to the rules applicable to nonqualified funds before becoming eligible for the special rules provided under the proposal for shareholders that are

subject to subpart F, the stock held by such shareholder would continue to be treated as PFIC stock unless the shareholder makes an election to pay tax and an interest charge with respect to the unrealized appreciation in the stock or the accumulated earnings of the corporation.

If, under the proposal, a shareholder is not subject to the PFIC provisions because the shareholder is subject to subpart F and the shareholder subsequently ceases to be subject to subpart F with respect to the corporation, for purposes of the PFIC provisions, the shareholder's holding period for such stock would be treated as beginning immediately after such cessation. Accordingly, in applying the rules applicable to PFICs that are not qualified electing funds, the earnings of the corporation would not be attributed to the period during which the shareholder was subject to subpart F with respect to the corporation and was not subject to the PFIC provisions.

Mark-to-market election

The proposal would allow a shareholder of a PFIC to make a mark-to-market election with respect to the stock of the PFIC, provided that such stock is marketable (as defined below). Under such an election, the shareholder would include in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder would be allowed a deduction for the excess, if any, of the adjusted basis of the PFIC stock over its fair market value as of the close of the taxable year. However, deductions would be allowable under this rule only to the extent of any net mark-to-market gains with respect to the stock included by the shareholder for prior taxable years.

Under the proposal, this mark-to-market election would be available only for PFIC stock that is "marketable." For this purpose, PFIC stock would be considered marketable if it is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission or on the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934. In addition, PFIC stock would be considered marketable if it is regularly traded on any exchange or market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a legitimate and sound fair market value. Any option on stock that is considered marketable under the foregoing rules would be treated as marketable, to the extent provided in regulations. PFIC stock also would be treated as marketable, to the extent provided in regulations, if the PFIC offers for sale (or has outstanding) stock of which it is the issuer and which is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the proposal would treat as marketable any PFIC stock owned by a RIC that offers for sale (or has outstanding) any stock of which it is the issuer and which is redeemable at its net asset value. The bill would treat as marketable any PFIC stock held by any other RIC that otherwise publishes net asset valuations at least annually, except to the extent provided in regulations.

The shareholder's adjusted basis in the PFIC stock would be adjusted to reflect the amounts included or deducted under this election. In the case of stock owned indirectly by a U.S. person through a foreign entity (as discussed below), the basis adjustments for mark-to-market gains and losses would apply to the basis of the PFIC in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFIC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments would be made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFIC stock.

Amounts included in income pursuant to a mark-to-market election, as well as gain on the actual sale or other disposition of the PFIC stock, would be treated as ordinary income. Ordinary loss treatment also would apply to the deductible portion of any mark-to-market loss on PFIC stock, as well as to any loss realized on the actual sale or other disposition of PFIC stock to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included with respect to such stock. The source of amounts with respect to a mark-to-market election generally would be determined in the same manner as if such amounts were gain or loss from the sale of stock in the PFIC.

An election to mark to market would apply to the taxable year for which made and all subsequent taxable years, unless the PFIC stock ceases to be marketable or the Secretary of the Treasury consents to the revocation of such election.

Under constructive ownership rules, U.S. persons that own PFIC stock through certain foreign entities could make this election with respect to the PFIC. These constructive ownership rules would apply to treat PFIC stock owned directly or indirectly by or for a foreign partnership, trust, or estate as owned proportionately by the partners or beneficiaries, except as provided in regulations. Stock in a PFIC that is thus treated as owned by a person would be treated as actually owned by that person for purposes of again applying the constructive ownership rules. In the case of a U.S. person that is treated as owning PFIC stock by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the PFIC stock, as well as any disposition by the person actually owning the PFIC stock, would be treated as a disposition by the U.S. person of the PFIC stock.

In addition, a CFC that owns stock in a PFIC would be treated as a U.S. person that could make the election with respect to such PFIC stock. Any amount includible (or deductible) in the CFC's gross income pursuant to this mark-to-market election would be treated as foreign personal holding company income (or a deduction allocable to foreign personal holding company income). The source of such amounts, however, would be determined by reference to the actual residence of the CFC.

In the case of a taxpayer that makes the mark-to-market election with respect to stock in a PFIC that is a nonqualified fund after the beginning of the taxpayer's holding period with respect to such stock, a coordination rule would apply to ensure that the taxpayer does not avoid the interest charge with respect to amounts attributable to periods before such election. A similar rule

would apply to RICs that make the mark-to-market election under this bill after the beginning of their holding period with respect to PFIC stock (to the extent that the regulated investment company had not previously marked to market the stock of the PFIC).

Except as provided in the coordination rules described above, the rules of section 1291 (with respect to nonqualified funds) would not apply to a shareholder of a PFIC if a mark-to-market election is in effect for the shareholder's taxable year. Moreover, in applying section 1291 in a case where a mark-to-market election was in effect for any prior taxable year, the shareholder's holding period for the PFIC stock would be treated as beginning immediately after the last taxable year for which such election applied.

A special rule applicable in the case of a PFIC shareholder that becomes a U.S. person would treat the adjusted basis of any PFIC stock held by such person on the first day of the year in which such shareholder becomes a U.S. person as equal to the greater of its fair market value on such date or its adjusted basis on such date. Such rule would apply only for purposes of the mark-to-market election.

Effective Date

The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

D. Simplify Formation and Operation of International Joint Ventures

Present Law

Under section 1491, an excise tax generally is imposed on transfers of property by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital or to a foreign partnership, estate or trust. The tax is 35 percent of the amount of gain inherent in the property transferred but not recognized for income tax purposes at the time of the transfer. However, several exceptions to the section 1491 excise tax are available. Under section 1494(c), a substantial penalty applies in the case of a failure to report a transfer described in section 1491.

Section 367 applies to require gain recognition upon certain transfers by U.S. persons to foreign corporations. Under section 367(d), a U.S. person that contributes intangible property to a foreign corporation is treated as having sold the property to the corporation and is treated as receiving deemed royalty payments from the corporation. These deemed royalty payments are treated as U.S. source income. A U.S. person may elect to apply similar rules to a transfer of intangible property to a foreign partnership that otherwise would be subject to the section 1491 excise tax.

A foreign partnership may be required to file a partnership return. If a foreign partnership fails to file a required return, losses and credits with respect to the partnership may be disallowed to the partnership. A U.S. person that acquires or disposes of an interest in a foreign partnership, or whose proportional interest in the partnership changes substantially, may be required to file an information return with respect to such event.

A partnership generally is considered to be a domestic partnership if it is created or organized in the United States or under the laws of the United States or any State. A foreign partnership generally is any partnership that is not a domestic partnership.

Description of Proposal

The proposal would repeal the section 1491 excise tax that applies to certain transfers of appreciated property by a U.S. person to a foreign entity. Instead of the excise tax that applies under present law to transfers to a foreign estate or trust, gain recognition would be required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust. Instead of the excise tax that applies under present law to certain transfers to foreign corporations, regulatory authority would be granted under section 367 to deny nonrecognition treatment to such a transfer in a transaction that is not described otherwise in section 367. Instead of the excise tax that applies under present law to transfers to foreign partnerships, regulatory authority would be granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain otherwise would be transferred to a foreign partner. In addition, regulatory authority would be granted to deny the nonrecognition treatment that is provided under section 1035 to certain exchanges of insurance policies, where the transfer is to a foreign person.

The proposal would repeal the rule that treats as U.S. source income any deemed royalty arising under section 367(d). Under the proposal, in the case of a transfer of intangible property to a foreign corporation, the deemed royalty payments under section 367(d) would be treated as foreign source income to the same extent that an actual royalty payment would be considered to be foreign source income. Regulatory authority would be granted to provide similar treatment in the case of a transfer of intangible property to a foreign partnership.

The proposal would provide detailed information reporting rules in the case of foreign partnerships. A foreign partnership generally would be required to file a partnership return for a taxable year if the partnership has U.S. source income or is engaged in a U.S. trade or business, except to the extent provided in regulations.

Under the proposal, reporting rules similar to those applicable under present law in the case of controlled foreign corporations would apply in the case of foreign partnerships. A U.S. partner that controls a foreign partnership would be required to file an annual information return with respect to such partnership. For this purpose, a U.S. partner would be considered to control a foreign partnership if the partner holds a 50 percent or greater interest in the capital, profits, or, to the extent provided in regulations, losses, of the partnership. To the extent provided in regulations, similar information reporting also would be required from a U.S. 10-percent partner of a foreign partnership that is controlled by U.S. 10-percent partners. A \$10,000 penalty would apply to a failure to comply with these reporting requirements; additional penalties of up to \$50,000 would apply in the case of continued noncompliance after notification by the Secretary of the Treasury. Under the proposal, the penalties for failure to report information with respect to a controlled foreign corporation would be conformed with these penalties.

Under the proposal, reporting by a U.S. person of an acquisition or disposition of an interest in a foreign partnership, or a change in the person's proportional interest in the partnership, would be required only in the case of acquisitions, dispositions, or changes involving at least a 10-percent interest. A \$10,000 penalty would apply to a failure to comply with these reporting requirements; additional penalties of up to \$50,000 would apply in the case of continued noncompliance after notification by the Secretary. Under the proposal, the penalties for failure to report information with respect to a foreign corporation would be conformed with these penalties.

Under the proposal, reporting rules similar to those applicable under present law in the case of transfers by U.S. persons to foreign corporations would apply in the case of transfers to foreign partnerships. These reporting rules would apply in the case of a transfer to a foreign partnership only if the U.S. person holds at least a 10-percent interest in the partnership or the value of the property transferred by such person to the partnership during a 12-month period exceeded \$100,000. A penalty equal to 10 percent of the value of the property transferred would apply to a failure to comply with these reporting requirements. Under the proposal, the penalty for failure to report transfers to a foreign corporation would be conformed with this penalty. In the case of a transfer to a foreign partnership, failure to comply also would result in gain recognition with respect to the property transferred.

Under the proposal, in the case of a failure to report required information with respect to a foreign corporation, partnership, or trust, the statute of limitations with respect to any event or period to which such information relates would not expire before the date that is three years after the date on which such information is provided.

Under the proposal, regulatory authority would be granted to provide rules treating a partnership as a foreign partnership where such treatment is more appropriate.

Effective Date

The proposals with respect to the repeal of section 1491 would be effective upon date of enactment. The proposal with respect to the source of a deemed royalty under section 367(d) also would be effective upon date of enactment.

The proposals regarding information reporting with respect to foreign partnerships generally would be effective for partnership taxable years beginning after date of enactment. The proposals regarding information reporting with respect to interests in, and transfers to, foreign partnerships would be effective for transfers to, and changes in interest in, foreign partnerships after date of enactment. Regulatory authority would be granted to allow taxpayers to apply these rules to transfers made after August 20, 1996. The proposal with respect to the statute of limitations in the case of noncompliance with reporting requirements would be effective for information returns due after date of enactment.

The proposal regarding the determination of the treatment of partnerships as foreign or domestic would be effective for partnership taxable years beginning after date of enactment.

E. Modification of Reporting Threshold for Stock Ownership of a Foreign Corporation

Present Law

Several provisions of the Code require U.S. persons to report information with respect to a foreign corporation in which they are shareholders or act as officers or directors. Sections 6038 and 6035 generally require every U.S. citizen or resident who is an officer, director or who owns at least 10 percent of the stock of a foreign corporation that is a controlled foreign corporation or a foreign personal holding company to file Form 5471 annually.

Section 6046 mandates the filing of information returns on behalf of a foreign corporation by certain U.S. persons upon the occurrence of certain events. U.S. persons required to file these information returns are those who own or acquire 5 percent or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership.

A failure to file the required information return under section 6038 could result in monetary penalties or reduction of foreign tax credit benefits. A failure to file the required information returns under sections 6035 or 6046 could result in monetary penalties.

Description of Proposal

The proposal would increase the threshold for stock ownership of a foreign corporation that results in information reporting obligations under section 6046 from 5 percent (based on value) to 10 percent (based on vote or value).

Effective Date

The proposal would be effective for reportable transactions occurring after December 31, 1997.

F. Other Foreign Simplification Provisions

1. Transition rule for certain trusts

Present Law

Under rules enacted with the Small Business Job Protection Act of 1996, a trust is considered to be a U.S. trust if two criteria are met. First, a court within the United States must be able to exercise primary supervision over the administration of the trust. Second, U.S. fiduciaries of the trust must have the authority to control all substantial decisions of the trust. A trust that does not satisfy both of these criteria is considered to be a foreign trust. These rules for defining a U.S. trust generally are effective for taxable years of a trust that begin after December 31, 1996. A trust that qualified as a U.S. trust under prior law could fail to qualify as a U.S. trust under these new criteria.

Description of Proposal

Under the proposal, the Secretary of the Treasury would be granted authority to allow nongrantor trusts that had been treated as U.S. trusts under prior law to elect to continue to be treated as U.S. trusts, notwithstanding the new criteria for qualification as a U.S. trust.

Effective Date

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

2. Simplify application of the stock and securities trading safe harbor

Present Law

A non-resident alien individual or foreign corporation that is engaged in a trade or business within the United States is subject to U.S. taxation on its net income that is effectively connected with the trade or business, at graduated rates of tax. Under a "safe harbor" rule, foreign persons that trade in stocks or securities for their own accounts are not treated as engaged in a U.S. trade or business for this purpose.

For a foreign corporation to qualify for the safe harbor, it must not be a dealer in stock or securities. In addition, if the principal business of the foreign corporation is trading in stock or securities for its own account, the safe harbor generally does not apply if the principal office of the corporation is in the United States.

For foreign persons who invest in securities trading partnerships, the safe harbor applies only if the partnership is not a dealer in stock and securities. In addition, if the principal business of the partnership is trading stock or securities for its own account, the safe harbor generally does not apply if the principal office of the partnership is in the United States.

Under Treasury regulations which apply to both corporations and partnerships, the determination of the location of the entity's principal office turns on the location of various functions relating to operation of the entity, including communication with investors and the general public, solicitation and acceptance of sales of interests, and maintenance and audits of its books of account (Treas. reg. sec. 1.864-2(c)(2)(iii)). Under the regulations, the location of the entity's principal office does not depend on the location of the entity's management or where investment decisions are made.

Description of Proposal

The proposal would modify the stock and securities trading safe harbor by eliminating the requirement for both corporations and partnerships that trade stock or securities for their own account that the entity's principal office not be within the United States.

Effective Date

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

G. Other Foreign Provisions

1. Inclusion of income from notional principal contracts and stock lending transactions under subpart F

Present Law

Under the subpart F rules, the U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1) property that gives rise to the foregoing types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. Income from notional principal contracts referenced to commodities, foreign currency, interest rates, or indices thereon is treated as foreign personal holding company income; income from equity swaps or other types of notional principal contracts is not treated as foreign personal holding company income. Income derived from transfers of debt securities (but not equity securities) pursuant to the rules governing securities lending transactions (sec. 1058) is treated as foreign personal holding company income.

Income earned by a CFC that is a regular dealer in the property sold or exchanged generally is excluded from the definition of foreign personal holding company income. However, no exception is available for a CFC that is a regular dealer in financial instruments referenced to commodities.

A U.S. shareholder of a passive foreign investment company ("PFIC") is subject to U.S. tax and an interest charge with respect to certain distributions from the PFIC and gains on dispositions of the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes its share of the earnings of the PFIC. A foreign corporation is a PFIC if it satisfies either a passive income test or a passive assets test. For this purpose, passive income is defined by reference to foreign personal holding company income.

Description of Proposal

The proposal would treat net income from all types of notional principal contracts as a new category of foreign personal holding company income. However, 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 included in that other category.

The proposal would treat payments in lieu of dividends derived from equity securities lending transactions pursuant to section 1058 as another new category of foreign personal holding company income.

The proposal would provide an exception from foreign personal holding company income for certain income, gain, deduction, or loss from transactions (including hedging transactions) entered into in the ordinary course of a CFC's business as a regular dealer in property, forward contracts, options, notional principal contracts, or similar financial instruments (including instruments referenced to commodities).

These modifications to the definition of foreign personal holding company income would apply for purposes of determining a foreign corporation's status as a PFIC.

Effective Date

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

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

Present Law

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

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

Description of Proposal

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

Effective Date

The proposal would be effective for exchanges after June 8, 1997, unless the exchange is pursuant to a binding contract in effect on such date and all times thereafter. A contract would not fail to be considered to be binding solely because (1) it provides for a sale in lieu of an exchange or (2) either the property to be disposed of as relinquished property or the property to be acquired as replacement property (whichever is applicable) was not identified under the contract before June 9, 1997.

3. Impose holding period requirement for claiming foreign tax credits with respect to dividends

Present Law

A U.S. person that receives a dividend from a foreign corporation generally is entitled to a credit for income taxes paid to a foreign government on the dividend, regardless of the U.S. person's holding period for the foreign corporation's stock. A U.S. corporation that receives a dividend from a foreign corporation in which it has a 10-percent or greater voting interest may also be entitled to a credit for the foreign taxes paid by the foreign corporation, also without regard to the U.S. shareholder's holding period for the corporation's stock (sections 902 and 960).

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. shareholders that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on dividends they receive.

Description of Proposal

The proposal would deny a shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for a minimum period during which it is not protected from risk of loss. Under the proposal, the minimum holding period for dividends on common stock would be 16 days. The minimum holding period for preferred stock would be 46 days.

Where the holding period requirement is not met for a dividend, the proposal would disallow the shareholder's foreign tax credits for (1) the foreign taxes that are paid on the dividend and (2) any foreign taxes paid by the foreign corporation for which the shareholder otherwise would be entitled to credits. Where the holding period requirement is not met for stock in a RIC, the proposal would disallow the shareholder's credits for foreign taxes paid by the RIC, which are treated as paid by the shareholders if the RIC so elects (section 853).

The proposal would deny these foreign tax credit benefits, regardless of the shareholder's holding period for the stock, to the extent that the taxpayer has an obligation to make payments related to the dividend (whether pursuant to a short sale or otherwise) with respect to substantially similar or related property.

The 16- or 46-day holding period (whichever applies) would be required to be satisfied over a period immediately before or immediately after the shareholder becomes entitled to receive each dividend. For purposes of determining whether the required holding period is met, any period during which the shareholder has protected itself from risk of loss (under the rules of section 246(c)(4)) would not be included. For example, assume a taxpayer buys foreign common stock. Assume also that, the day after stock is purchased, the taxpayer enters into an equity swap under which the taxpayer is entitled to receive payments equal to the losses on the stock, and the taxpayer retains the swap position for the entire period it holds the stock. Under the proposal, the taxpayer would not be able to claim any foreign tax credits with respect to dividends on the stock because the taxpayer's holding period would be limited to the single day during which the loss on the stock was not protected.

The proposal would provide an exception for foreign tax credits with respect to certain dividends received by active dealers in securities. In order to qualify for the exception, the following requirements would have to be met (1) the dividend must be received by the entity on stock which it holds in its capacity as a dealer in securities, (2) the entity must be subject to net income taxation on the dividend (on either a residence or worldwide income basis) in a foreign country, and (3) the foreign taxes to which the exception applies must be taxes that are creditable under the foreign country's tax system. A securities dealer for purposes of the exception must be an entity which (1) regularly enters into stock or securities transactions with customers (section 475(c)(1)) and (2) is registered as a securities dealer under the Securities Exchange Act of 1934 or is licensed or authorized to sell stock to or from customers and subject to bona fide regulation by the securities regulatory authority of the foreign country in which the relevant dividend is subject to net-basis taxation. Under the proposal, the Treasury is granted authority to issue regulations necessary or appropriate to prevent abuse of this exception.

If a taxpayer is denied foreign tax credits under the proposal because the 16- or 46-day holding period requirement is not satisfied, the taxpayer would be entitled to a deduction for the foreign taxes for which the credit is disallowed. This deduction would be available even if the taxpayer claimed the foreign tax credit for other taxes in the same taxable year.

Effective Date

The proposal would be effective for dividends paid or accrued more than 30 days after the date of enactment.

4. Penalties for failure to file disclosure of exemption for income from the international operation of ships or aircraft by foreign persons

Present Law

The United States generally imposes a 4-percent tax on the U.S.-source gross transportation income of foreign persons that is not effectively connected with the foreign person's

conduct of a U.S. trade or business (sec. 887). Foreign persons generally are subject to U.S. tax at regular graduated rates on net income, including transportation income, that is effectively connected with a U.S. trade or business (secs. 871(b) and 882).

Transportation income is any income derived from, or in connection with, the use (or hiring or leasing for use) of a vessel or aircraft (or a container used in connection therewith) or the performance of services directly related to such use (sec. 863(c)(3)). Income attributable to transportation that begins and ends in the United States is treated as derived from sources in the United States (sec. 863(c)(1)). In the case of transportation that either begins or ends in the United States, generally 50 percent of such income is treated as U.S. source and 50 percent is treated as foreign source (sec. 863(c)(2)). U.S.-source transportation income is treated as effectively connected with a foreign person's conduct of U.S. trade or business only if the foreign person has a fixed place of business in the United States that is involved in the earning of such income and substantially all of such income of the foreign person is attributable to regularly scheduled transportation (sec. 887(b)(4)).

An exemption from U.S. tax is provided for income derived by a nonresident alien individual or foreign corporation from the international operation of a ship or aircraft, provided that the foreign country in which such individual is resident or such corporation is organized grants an equivalent exemption to individual residents of the United States or corporations organized in the United States (secs. 872(b)(1) and (2) and 883(a)(1) and (2)).

Description of Proposal

Under the proposal, a foreign person that claims exemption from U.S. tax for income from the international operation of ships or aircraft, but does not satisfy the filing requirements for claiming such exemption, would be subject to the penalty of the denial of such exemption and any deductions or credits otherwise allowable in determining the U.S. tax liability with respect to such income. If a foreign person that has a fixed place of business in the United States fails to satisfy the filing requirements for claiming an exemption from U.S. tax for its income from the international operation of ships or aircraft, such person would be subject to the additional penalty that foreign source income from the international operation of ships or aircraft would be treated as effectively connected with the conduct of a U.S. trade or business, but only to the extent that such income is attributable to such fixed place of business in the United States. Income so treated as effectively connected with a U.S. business would be subject to U.S. tax at graduated rates (and would be subject to the disallowance of deductions and credits described above). The proposal would not apply to the extent the application would be contrary to any treaty obligation of the United States. The proposal also would provide for the provision of information by the U.S. Customs Service to the Secretary of the Treasury regarding foreign-flag ships engaged in shipping to or from the United States.

Effective Date

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

5. Limitation on treaty benefits for payments to hybrid entities

Present Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) that are engaged in business in the United States are subject to U.S. tax on the income from such business in the same manner as a U.S. person. In addition, the United States imposes tax on certain types of U.S. source income, including interest, dividends and royalties, of foreign persons not engaged in business in the United States. Such tax is imposed on a gross basis and is collected through withholding. The statutory rate of this withholding tax is 30 percent. However, most U.S. income tax treaties provide for a reduction in rate, or elimination, of this withholding tax. Treaties generally provide for different applicable withholding tax rates for different types of income. Moreover, the applicable withholding tax rates differ among treaties. The specific withholding tax rates pursuant to a treaty are the result of negotiations between the United States and the treaty partner.

The application of the withholding tax is more complicated in the case of income derived through an entity, such as a limited liability company, that is treated as a partnership for U.S. tax purposes but may be treated as a corporation for purposes of the tax laws of a treaty partner. The Treasury regulations include specific rules that apply in the case of income derived through an entity that is treated as a partnership for U.S. tax purposes. In the case of a payment of an item of U.S. source income to a U.S. partnership, the partnership is required to impose the withholding tax to the extent the item of income is includible in the distributive share of a partner who is a foreign person. Tax-avoidance opportunities may arise in applying the reduced rates of withholding tax provided under a treaty to cases involving income derived through a limited liability company or other hybrid entity (e.g., an entity that is treated as a partnership for U.S. tax purposes but as a corporation for purposes of the treaty partner's tax laws). Regulations that have been proposed but not yet finalized would address this issue in the case of an item received by a foreign entity by allowing an interest holder in that entity to claim a reduced rate of withholding tax with respect to that item under a treaty only if the treaty partner requires the interest holder to include in income its distributive share of the entity's income on a flow-through basis. Prop. Treas. Reg. Sec. 1.1441-6(b)(4). This provision in the proposed regulations does not apply in the case of a U.S. entity.

Description of Proposal

The proposal would limit the availability of a reduced rate of withholding tax pursuant to an income tax treaty in order to prevent tax avoidance. Under the proposal, a foreign person would be entitled to a reduced rate of withholding tax under a treaty with a foreign country on an item of income derived through an entity that is treated as a partnership for U.S. tax purposes only if such item is treated for purposes of the taxation laws of such foreign country as an item of income of such person. This rule would not apply if the treaty itself contains a provision addressing the applicability of the treaty in the case of income derived through a partnership.

Moreover, the rule would not apply if the foreign country imposes tax on an actual distribution of such item of income from such partnership to such person.

This proposal would address a potential tax-avoidance opportunity for Canadian corporations with U.S. subsidiaries that arises because of the interaction between the U.S. tax law, the Canadian tax law, and the income tax treaty between the United States and Canada. Through the use of a U.S. limited liability company, which is treated as a partnership for U.S. tax purposes but as a corporation for Canadian tax purposes, a payment of interest (which is deductible for U.S. tax purposes) may be converted into a dividend (which is excludable for Canadian tax purposes). Accordingly, interest paid by a U.S. subsidiary through a U.S. limited liability company to a Canadian parent corporation would be deducted by the U.S. subsidiary for U.S. tax purposes and would be excluded by the Canadian parent corporation for Canadian tax purposes; the only tax on such interest would be a U.S. withholding tax, which may be imposed at a reduced rate of 10 percent (rather than the full statutory rate of 30 percent) pursuant to the income tax treaty between the United States and Canada. Under the proposal, withholding tax would be imposed at the full statutory rate of 30 percent in such case. The proposal would not apply if the U.S.-Canadian income tax treaty is amended to include a provision reaching a similar result. In this regard, the United States and Canada recently negotiated a proposed protocol that would amend the provision in the treaty governing cross-border social security payments and this issue could be addressed in the context of that protocol or an additional protocol. Moreover, the proposal would not apply if Canada were to impose tax on the Canadian parent on dividends received from the U.S. limited liability company.

Effective Date

The proposal would be effective upon date of enactment.

6. Clarification of determination of foreign taxes deemed paid

Present Law

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of such dividend to the foreign corporation's post-1986 undistributed earnings. The foreign corporation's post-1986 foreign income taxes is the sum of the foreign income taxes with respect to the taxable year in which the dividend is distributed plus certain foreign income taxes with respect to prior taxable years (beginning after December 31, 1986).

Description of Proposal

The proposal would clarify that, for purposes of the deemed paid credit under section 902 for a taxable year, a foreign corporation's post-1986 foreign income taxes would include foreign income taxes with respect to prior taxable years (beginning after December 31, 1986) only to the extent such taxes are not attributable to dividends distributed by the foreign corporation in prior taxable years. No inference would be intended regarding the determination of foreign taxes deemed paid under present law.

Effective Date

The proposal would be effective on date of enactment.

7. Clarification of foreign tax credit limitation for financial services income

Present Law

Under section 904, separate foreign tax credit limitations apply to various categories of income. Two of these separate limitation categories are passive income and financial services income. For purposes of the separate foreign tax credit limitation applicable to passive income, certain income that is treated as high-taxed income is excluded from the definition of passive income. For purposes of the separate foreign tax credit limitation applicable to financial services income, the definition of financial services income incorporates passive income as defined for purposes of the separate limitation applicable to passive income.

Description of Proposal

The proposal would clarify that the exclusion of income that is treated as high-taxed income does not apply for purposes of the separate foreign tax credit limitation applicable to financial services income. No inference would be intended regarding the treatment of high-taxed income for purposes of the separate foreign tax credit limitation applicable to financial services income under present law.

Effective Date

The proposal would be effective on date of enactment.

8. Interest on underpayment reduced by foreign tax credit carryback

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. 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. Separate

limitations are applied to specific categories of income. The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years.

For purposes of the computation of interest on overpayments of tax, if an overpayment for a taxable year results from a foreign tax credit carryback from a subsequent taxable year, the overpayment is deemed not to arise prior to the filing date for the subsequent taxable year in which the foreign taxes were paid or accrued (sec. 6611(g)). In Fluor Corp. v. United States, 35 Fed. Cl. 520 (1996), the court held that in the case of an underpayment of tax (rather than an overpayment) for a taxable year that is eliminated by a foreign tax credit carryback from a subsequent taxable year, interest does not accrue on the underpayment that is eliminated by the foreign tax credit carryback. The Government has filed an appeal in the Fluor case.

Description of Proposal

Under the proposal, if an underpayment for a taxable year is reduced or eliminated by a foreign tax credit carryback from a subsequent taxable year, such carryback would not affect the computation of interest on the underpayment for the period ending with the filing date for such subsequent taxable year in which the foreign taxes were paid or accrued. The proposal also would clarify the application of the interest rules of both section 6601 and section 6611 in the case of a foreign tax credit carryback that is triggered by a net operating loss, net capital loss or other credit carryback. No inference would be intended regarding the computation under present law of interest on underpayments that are reduced or eliminated by a foreign tax credit carryback.

Effective Date

The proposal would be effective for foreign taxes actually paid or accrued in taxable years beginning after date of enactment.

9. Determination of period of limitations relating to foreign tax credits

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. 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. Separate limitations are applied to specific categories of income. The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years.

For purposes of the period of limitations on filing claims for credit or refund, in the case of a claim relating to an overpayment attributable to foreign tax credits, the limitations period is ten years from the filing date for the taxable year with respect to which the claim is made. The Internal Revenue Service has taken the position that, in the case of a foreign tax credit

carryforward, the period of limitations is determined by reference to the year in which the foreign taxes were paid or accrued (and not the year to which the foreign tax credits are carried) (Rev. Rul. 84-125, 1984-2 C.B. 125). However, the court in Ampex Corp. v. United States, 620 F.2d 853 (1980), held that, in the case of a foreign tax credit carryforward, the period of limitations is determined by reference to the year to which the foreign tax credits are carried (and not the year in which the foreign taxes were paid or accrued).

Description of Proposal

Under the proposal, in the case of a claim relating to an overpayment attributable to foreign tax credits, the limitations period would be determined by reference to the year in which the foreign taxes were paid or accrued (and not the year to which the foreign tax credits are carried). No inference would be intended regarding the determination of such limitations period under present law.

Effective Date

The proposal would be effective for foreign taxes paid or accrued in taxable years beginning after date of enactment.

XII. EARNED INCOME CREDIT COMPLIANCE MEASURES

Overview

Certain eligible low-income workers are entitled to claim a refundable earned income credit on their income tax return. A refundable credit is a credit that not only reduces an individual's tax liability but allows refunds to the individual in excess of income tax liability. 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 individual's¹²³ 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. The credit is reduced by the amount of the alternative minimum tax ("AMT") the taxpayer owes for the year. The credit is phased out above certain income levels. For individuals 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 individuals with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed. The definition of AGI used for phasing out the earned income credit disregards certain losses. The losses disregarded are: (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 losses from business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses. Also, an individual is not eligible for the earned income credit if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds \$2,250. Disqualified income is the sum of: (1) interest (taxable and tax-exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gain net income; and (5) net passive income (if greater than zero) that is not self-employment income. The earned income amount, the phaseout amount and the disqualified income amount are indexed for inflation.

The parameters for the credit depend upon the number of qualifying children the individual claims. For 1997, the parameters are given in the following table:

¹²³ In the case of a married individual who files a joint return with his or her spouse, the income for purposes of these tests is the combined income of the couple.

Present-Law Earned Income Credit Parameters

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)	40.00	34.00	7.65
Earned income amount	\$9,140	\$6,500	\$4,340
Maximum credit	\$3,656	\$2,210	\$332
Phaseout begins	\$11,930	\$11,930	\$5,430
Phaseout rate (percent)	21.06	15.98	7.65
Phaseout ends	\$29,290	\$25,760	\$9,770

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.

A. Deny EIC Eligibility for Prior Acts of Recklessness or Fraud

Present Law

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation overstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement (sec. 6662). Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code.

The fraud penalty, which is imposed at a rate of 75 percent, applies to the portion of any underpayment that is attributable to fraud (sec. 6663).

Neither the accuracy-related penalty nor the fraud penalty is imposed with respect to any portion of an underpayment if it is shown that there was a reasonable cause for that portion and that the taxpayer acted in good faith with respect to that portion.

Description of Proposal

A taxpayer who fraudulently claims the earned income credit (EIC) would be ineligible to claim the EIC for a subsequent period of 10 years. In addition, a taxpayer who erroneously claims the EIC due to reckless or intentional disregard of rules or regulations would be ineligible to claim the EIC for a subsequent period of two years. These sanctions would be in addition to any other penalty imposed under present law. The determination of fraud or of reckless or intentional disregard of rules or regulations would be made in a deficiency proceeding (which would provide for judicial review).

Effective Date

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

B. Recertification Required When Taxpayer Found to Be Ineligible for EIC in Past

Present law

If an individual fails to provide a correct TIN and claims the EIC, such omission is treated as a mathematical or clerical error. Also, if an individual who claims the EIC with respect to net earnings from self employment fails to pay the proper amount of self-employment tax on such net earnings, the failure is treated as a mathematical or clerical error for purposes of the amount of EIC claimed. Generally, taxpayers have 60 days in which they can either provide a correct TIN or request that the IRS follow the current-law deficiency procedures. If a taxpayer fails to respond within this period, he or she must file an amended return with a correct TIN or clarify that any self-employment tax has been paid in order to obtain the EIC originally claimed.

The IRS must follow deficiency procedures when investigating other types of questionable EIC claims. Under these procedures, contact letters are first sent to the taxpayer. If the necessary information is not provided by the taxpayer, a statutory notice of deficiency is sent by certified mail, notifying the taxpayer that the adjustment will be assessed unless the taxpayer files a petition in Tax Court within 90 days. If a petition is not filed within that time and there is no other response to the statutory notice, the assessment is made and the EIC is denied.

Description of Proposal

A taxpayer who has been denied the EIC as a result of deficiency procedures would be ineligible to claim the EIC in subsequent years unless evidence of eligibility for the credit is provided by the taxpayer. To demonstrate current eligibility, the taxpayer would be required to meet evidentiary requirements established by the Secretary of the Treasury. Failure to provide this information when claiming the EIC would be treated as a mathematical or clerical error. If a taxpayer is recertified as eligible for the credit, the taxpayer would not be required to provide this information in the future unless the IRS again denies the EIC as a result of a deficiency procedure. Ineligibility for the EIC under the proposal would be subject to review by the courts.

Effective Date

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

C. Due Diligence Requirements for Paid Preparers

Present Law

There are several penalties that apply in the case of an understatement of tax that is caused by an income tax return preparer. First, if any part of an understatement of tax on a return or claim for refund is attributable to a position for which there was not a realistic possibility of being sustained on its merits and if any person who is an income tax return preparer with respect to such return or claim for refund knew (or reasonably should have known) of such position and such position was not disclosed or was frivolous, then that return preparer is subject to a penalty of \$250 with respect to that return or claim (sec. 6694(a)). The penalty is not imposed if there is reasonable cause for the understatement and the return preparer acted in good faith.

In addition, if any part of an understatement of tax on a return or claim for refund is attributable to a willful attempt by an income tax return preparer to understate the tax liability of another person or to any reckless or intentional disregard of rules or regulations by an income tax return preparer, then the income tax return preparer is subject to a penalty of \$1,000 with respect to that return or claim (sec. 6694(b)).

Also, a penalty for aiding and abetting the understatement of tax liability is imposed in cases where any person aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document were so used, an understatement of the tax liability of another person would result (sec. 6701).

Additional penalties are imposed on return preparers with respect to each failure to (1) furnish a copy of a return or claim for refund to the taxpayer, (2) sign the return or claim for refund, (3) furnish his or her identifying number, (4) retain a copy or list of the returns prepared, and (5) file a correct information return (sec. 6695). The penalty is \$50 for each failure and the total penalties imposed for any single type of failure for any calendar year are limited to \$25,000.

Description of Proposal

Return preparers would be required to fulfill certain due diligence requirements with respect to returns they prepare claiming the EIC. The penalty for failure to meet these requirements would be \$100. This penalty would be in addition to any other penalty imposed under present law.

Effective Date

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

XIII. INCREASE IN PUBLIC DEBT LIMIT

Present Law

The statutory limit on the public debt currently is \$5.5 trillion. It was set at this level in P.L. 104-121, enacted into law on March 29, 1996.

Description of Proposal

The proposal would increase the statutory limit on the public debt to \$5.95 trillion.

Effective Date

The proposal would be effective on the date of enactment.