DESCRIPTION AND ANALYSIS OF CERTAIN REVENUE-RAISING PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1998 BUDGET PROPOSAL

Scheduled for a Public Hearing

Before the

HOUSE COMMITTEE ON WAYS AND MEANS

on March 12, 1997

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on March 12, 1997, on certain revenue-raising provisions contained in the President's fiscal year 1998 budget proposal, as submitted to the Congress on February 6, 1997.[1] This document,[2] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of these provisions.

This document does not include a description of certain user fees and other proposals contained in the President's fiscal year 1998 budget proposal that may or may not be considered to be in the jurisdiction of the House Committee on Ways and Means.[3] In addition, the document does not describe or analyze proposals relating to Airport and Airway Trust Fund, Oil Spill Liability Trust Fund, Superfund, and Leaking Underground Storage Tank Trust Fund excise taxes and the proposal to extend the Superfund corporate environmental tax which will be considered later this year.

Part I of this document describes and analyzes the tax proposals relating to financial product, corporate and foreign tax provisions, and Part II describes and analyzes the other revenue-raising tax proposals.

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[1] See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals, February 1997*. Also, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998: Analytical Perspectives*, pp. 45-60.

[2] This document may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCX-10-97), March 11, 1997. For descriptions and revenue estimates for all the revenue provisions in the President's fiscal year 1998 budget proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCX-6-97R), February 10, 1997, and Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 1998 Budget Proposal* (JCX-8-97), February 27, 1997.

[3] See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998: Analytical Perspectives*, pp. 61-69.

I. FINANCIAL, CORPORATE, AND FOREIGN TAX PROVISIONS

A. Provisions Relating to Financial Products

1. 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.

Section 385 of the Code provides the Treasury Department with authority to issue regulations classifying certain types of instruments as debt or equity. Although proposed and final regulations have been issued several times under this provision, these regulations have been withdrawn and there are no current regulations that apply under this section.

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

Description of Proposal

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

are convertible at the holder's option when it is substantially certain that the right will be exercised. This proposal would not affect the treatment of a holder of an instrument.

For purposes of determining the weighted average maturity of an instrument or the term of an instrument, any right to extend, renew, or relend will be treated as exercised and any right to accelerate payment will be ignored.

The proposal would also clarify that for purposes of section 385(c), an issuer will be treated as having characterized an instrument as equity if the instrument (1) has a maximum term of more than 15 years, and (2) is not shown as indebtedness on the separate balance sheet of the issuer. For this purpose, in the case of an instrument with a maximum term of more than 15 years issued to a related party (other than a corporation) that is eliminated in the consolidated balance sheet that includes the issuer and the holder, the issuer will be treated as having characterized the instrument as equity if the holder or some other related party issues a related instrument that is not shown as indebtedness on the consolidated balance sheet. For this purpose, an instrument would not be treated as shown as indebtedness on a balance sheet because it is described as such in footnotes or other narrative disclosures. The proposal would apply only to corporations that file annual financial statements (or are included in financial statements filed) with the Securities and Exchange Commission (SEC), and the relevant balance sheet is the balance sheet filed with the SEC. In addition, this proposal would not apply to leveraged leases.

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

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

Effective Date

The proposal would be effective generally for instruments issued on or after the date of first committee action.

Analysis

In general

Under present law, taxpayers have significant flexibility in determining whether to characterize an instrument as debt or equity. Frequently, instruments with very similar economic terms may be characterized as equity if it is desired to market them to corporate holders that would benefit from a dividends received deduction, or as debt if it is desired to take a corporate level interest deduction or achieve certain other benefits of debt status.

In general, characterization of an instrument as debt can be based on a number of factors, including that there is a promise to pay a specified amount at a specified time, provided there is a reasonable expectation that the terms of the instrument will be met. Analysis of the likelihood

that an instrument will be paid in accordance with its terms can be a complex and difficult administrative issue. The term of an instrument can be a factor, though it is not the only factor, in characterizing instruments under present law.

Congress has long recognized that there have been administrative and practical difficulties and numerous issues regarding the classification of instruments as debt or equity, and has (in section 385) authorized the Treasury Department to issue regulations addressing the issue. However, the history of various Treasury proposed regulations, each of which has been withdrawn, reflects in large part the difficulty of limiting taxpayer opportunities by bright-line classifications, without opening equally significant problems through a full recharacterization that will make other anomalous results or planning opportunities possible.

Specific components of proposal

The proposal involves three separable provisions, each of which is discussed separately below. The first two provisions would deny a corporate interest deduction for interest (but would not otherwise recharacterize as equity) certain types of instruments that could be classified as debt under present law. The third provision would generally characterize certain other instruments as equity for all tax purposes.

(1) Deny interest deduction on long-term debt

This proposal would deny a corporate interest deduction (or a deduction for original issue discount) in the case of debt with a maximum weighted average maturity of more than 40 years. For purposes of determining such weighted average maturity, any right to extend, renew, or relend would be treated as exercised and any right to accelerate payment would be ignored.

Under present law, corporations have issued instruments with quite long maturities-- for example, 100-years--that they characterize as debt. In general, an instrument can be treated as debt based on a number of factors, including that there is a promise to pay at a time certain and a specified amount, and there is a reasonable expectation that such payment could actually occur. Under the proposal, corporate interest paid on debt with a weighted average maturity of more than 40 years would not be deductible, without further analysis of other facts and circumstances.

Some argue that an extremely long term is a factor indicating increased risk that an instrument may not in fact be paid in accordance with its terms when due, the fundamental expectation associated with debt characterization. It is argued that a corporation should not be able to obtain the benefit of an interest deduction for such a long term investment. Even if the instrument provides for acceleration in case of bankruptcy, it is argued that acceleration and a priority in bankruptcy is not equivalent to actual full payment; and that the longer the term, the more likely that an intervening event such as bankruptcy may substantially diminish an investor's recovery on the instrument.

It is also argued that payment of principal is a factor that should be taken into account in

determining whether an instrument is debt or equity. It is argued that if principal is not to be repaid under the terms of the instrument until very far in the future, the present value of the principal repayment amount is so low that the investor is likely not taking repayment of principal into account when deciding to make the investment.

The denial of a corporate interest deduction alone is arguably an appropriate attempt to reduce the tax benefits of characterizing an instrument as debt, while limiting the tax advantages that could be gained from a statutory recharacterization of the instrument as equity notwithstanding that the corporate issuer itself chose to denominate the instrument as debt. Also, full recharacterization as equity would potentially involve a wide range of issues, including whether the instrument should be treated as stock for purposes of the corporate reorganization provisions or for purposes of taxing foreign holders under Code and treaty provisions. Equity treatment for such cases could be viewed as best left to cases where the corporation itself chooses to characterize an instrument as equity.

Others argue that some of the ratings of even very long term debt from rating agencies are in some instances very high, suggesting a strong expectation of repayment, and that the term alone should not be the sole definitive factor in determining whether an instrument is debt or equity. It has not been the sole factor under existing case law, and is not mentioned as a factor under present law section 385.[4] Furthermore, it is argued that a corporation (and its investors) should be permitted to lock in a certain interest rate for an extremely long term if desired, without losing an interest deduction..

Also, it is argued that an instrument should be characterized either as debt or as equity but should not be denied the benefits of debt without being accorded the benefits of equity.

In addition, it is argued that many corporations would simply continue to issue very long term debt but just under the term prescribed by the new rule--for example, 39-year debt.

(2) Deny corporate interest deduction for debt that is payable in stock of the issuer or a related party.

Under present law, corporations frequently issue instruments denominated as debt but permitting (or requiring) the issuer to pay interest or principal or both by giving the holder stock of the issuer (or a related party).

The proposal applies only to situations where the investor has no option to be paid other than in stock, as the issuer has promised or has the option to require. Some observers have

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[4] Section 385(b)(1) refers to an unconditional promise to pay but does not refer to the present value of the promise. See Notice 94-47, 1994-1 C.B. 357, stating that the reasonableness of an instrument's term is determined based on all the facts and circumstances, including the issuer's ability to satisfy the instrument.

argued that a corporation should not receive an interest deduction for obligations that may be paid in its own stock, since the instrument could be viewed as a forward purchase of stock by the investor, rather than as an investment in a debt investment. Furthermore, in many cases the investment is not equivalent to a receipt of cash followed by a purchase of stock, because in this case the corporation has agreed in advance to sell stock to the investor at a specified time and for a specified price.

The denial of interest only, rather than full recharacterization of the instrument as equity, is defended on the same grounds as in the case of proposal 1. These are, that the taxpayer should not obtain new benefits against its own chosen form of instrument, that full recharacterization of an instrument would raise issues for many Code purposes, and that allowing the taxpayer to recharacterize against its form may open new opportunities for anomalies, which has arguably been the downfall of attempts to effectively limit planning opportunities under present law. In addition, it is argued that a forward sale of stock (the transaction that these instruments arguably resemble) is not an immediate transfer of a stock interest, and would not produce an equity instrument eligible for a dividends-received deduction or other aspects of corporate equity treatment until the stock transfer occurred.[5]

Others view the instrument as giving a corporation the ability to lower interest rates by offering the investment to those investors who may prefer to receive stock.

It is also sometimes argued that the proposal covers not only cases where a corporation has the option (or is required) to pay the instrument with a particular amount of stock (whose value may fluctuate), but also cases where the corporation must pay a fixed amount of value, determined at the time the instrument is issued (even though the value may be in the form of stock). It is argued that in the latter case, the corporation could alternatively have paid the instrument in cash and then issued stock of equal value to investors, while the investor could have used the cash received to purchase stock. It is argued that if that case would obtain an interest deduction, there is arguably no reason to deny an interest deduction if the corporation instead has the option (or can require) the investor to take stock of value equal to the specified amount of cash in the first instance. On the other hand, it could be argued that under the form of transaction covered by the proposal, the corporation is assured that it will be able to issue stock in the amount required to pay the debt, at the time the debt is due.

The argument is also made that an instrument should be treated as debt or equity and that merely denying interest deductions without full recharacterization is not appropriate.

(3) Certain instruments not reflected as financial statement debt treated as equity under section 385(c) of the Code.

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[5] A pre-paid forward contract could involve an element of interest with different amounts and timing than claimed under the debt instrument. The proposal takes the approach of not permitting a favorable recharacterization against the form chosen by the taxpayer.

There have been numerous reported instances in which corporations have issued instruments through back-to-back arrangements with partnership or trust conduits, that offer the issuer an interest deduction but are not treated as debt for financial statement purposes. The instruments are commonly referred to as "deductible preferred stock" and are reportedly largely replacing regular preferred stock issuances in today's market.[6]

One example of such a case involves a corporation that issues its debt to a partnership or trust, which in turn issues preferred interests to investors. (One acronym for such instruments is Monthly Income Preferred Shares, or "MIPS"; another acronym for similar securities is Trust Originated Preferred Securities, or "TOPRS"). The corporate debt payments fund the preferred payments to investors. Investors have equity, not a debt claim against the partnership or trust. However, the trust fiduciary has an obligation to make payments to investors and to collect on the corporate instrument if necessary. The features of the equity investment, and of the corporate instrument backing the equity investment, may vary.

Certain types of these instruments have become desirable for banks, since the Federal Reserve Board has stated that if the arrangement involves certain features it can qualify as Tier 1 equity capital for banks. The features required for such treatment include an ability to skip or defer payments to investors for a least 5 consecutive years and a corporate debt instrument backing the arrangement that has the longest feasible term and is subordinated to all subordinated debt.[7]

It is argued that if a corporation is entitled under financial accounting rules to exclude an instrument from debt on its balance sheet, then the corporation should not be permitted to treat the arrangement as debt for Federal income tax purposes. Moreover, it is argued, the extent to which these securities have displaced preferred stock may suggest that the instruments are viewed in the marketplace as having similar features.

The Administration proposal recharacterizes the instrument as equity for all tax purposes by treating the instrument as so characterized by the issuer under section 385(c). That section requires the holder of an instrument to treat it in the same manner as characterized by the issuer,

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[6] See, e.g., Bary, "Preferred Vehicle--How Goldman, Merrill altered an entire market" *Barron's* p. 13 (August 21, 1995).

[7] See, Federal Reserve Press Release, October 21, 1996 ("To be eligible as Tier 1 capital, such instruments must provide for a minimum five-year consecutive deferral period on distributions to preferred shareholders. In addition, the intercompany loan must be subordinated to all subordinated debt and have the longest feasible maturity.") . See also "Capital Briefs--Rule on Cumulative Preferred Stock Eased," *American Banker* (October 22, 1996); Padgett, "Surge of New Issues Seen as Fed Approves Use of Hybrid Security," *American Banker* (October 24, 1996).

unless the holder expressly notifies the IRS that it is taking the position of a different classification for its own tax position. Any lack of clarity regarding this treatment would be avoided by characterizing the instrument that the corporation issued to the trust or partnership as equity of the corporation, such that the partners or trust holders would hold interests in an entity that owned corporate stock (rather than themselves being treated as owning corporate stock).

On the other hand, some argue that financial statement characterization has not traditionally governed characterization for tax purposes. This is so because the goals of generally accepted accounting principles and income tax rules are often different. It is also argued that the proposal's application only to instruments with a term of more than 15 years might in some cases be avoided by reducing the term.

2. Defer interest deduction on certain convertible debt

Present Law

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

Other convertible instruments may be issued with coupon interest, rather than OID, and may provide that if the debt is converted into stock, the holder does not receive any interest that accrued but was unpaid between the latest coupon date and the conversion date. Under present law, the issuer of such instrument generally cannot deduct such accrued but unpaid interest.[8]

Description of Proposal

The proposal would defer interest deductions on convertible debt until such time as the interest is paid. For this purpose, payment would not include: (1) the conversion of the debt into equity of the issuer or a related person (as determined under secs. 267(b) and 707(b)) or (2) the payment of cash or other property in an amount that is determined by reference to the amount of such equity. Convertible debt would include debt: (1) exchangeable into the stock of a party related to the issuer, (2) with cash-settlement conversion features, or (3) issued with warrants (or

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

similar instruments) as part of an investment unit in which the debt instrument may be used to satisfy the exercise price of the warrant. Convertible debt would not include debt that is "convertible" because a fixed payment of principal or interest could be converted by the holder into equity of the issuer or a related party having a value equal to the amount of such principal or interest. Holders of convertible debt would continue to include the interest on such instruments in gross income as under present law.

Effective Date

The proposal would be effective for convertible debt issued on or after the date of first committee action.

Analysis

The manner in which the proposal would operate may best be illustrated by examining its effect upon the tax treatment of instruments commonly known as liquid yield option notes ("LYONs").[9] A LYON generally is an instrument that is issued at a discount and is convertible into a fixed number of shares of the issuer, regardless of the amount of original issue discount ("OID") accrued as of the date of conversion. The conversion option usually is in the hands of the holder, although a LYON may be structured to allow the issuer to "cash out" the instrument at certain fixed dates for its issue price plus accrued OID. If the LYON is not converted into equity at maturity, the holder receives the issue price plus accrued OID. A LYON is somewhat different than more traditional convertible debt in that a LYON is convertible into a fixed number of shares of issuer stock regardless of the amount of accrued OID and does not provide interim interest payments to holders. Thus, a LYON could be viewed as providing the holder both a discount debt instrument and an option to purchase stock at a price equal to the maturity value of the debt. If the stock has risen in value from the date of issuance to the maturity date to an amount that is greater than the stated redemption price at maturity of the OID debt, the holder will exercise the option to acquire stock by surrendering the debt. If the stock has not sufficiently risen in value, the holder will cash in the debt and let the option lapse.

As a simplified example, assume ABC Co. issues a LYON that will mature in five years. The LYON provides that, at maturity, the holder has the option of receiving $100 cash or one share of ABC Co. stock. The LYONs are issued for $70 per instrument at time that the ABC Co. stock is trading for less than $70 a share. Thus, at the end of five years, the holder of the LYON has the following choices: (1) if ABC Co. stock is trading at less than $100 a share, the holder will take the $100 cash, but (2) if ABC Co. stock is trading at more than $100 a share, the holder will take the stock. Because the holder is guaranteed to receive at least $100 in value at maturity, present law allows the issuer (and requires the holder) to accrue $30 of OID as interest

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[9] Other convertible debt instruments may have features similar to LYONs and may be issued or traded under different names or acronyms. The reference to "LYONs" in this discussion is intended to be a reference to any other similar instruments.

over the five-year term of the instrument.

The structure of LYONs raises several tax issues. The first is whether the conversion feature of a LYON is sufficiently equity-like to characterize the LYON as equity instead of debt. Under present law, issuers of LYONS deduct (and the holders include in income) the amount of OID as interest as it accrues. A second issue is whether it is appropriate to accrue OID on an instrument when it is unclear whether such instrument (including the accrued OID) will be paid in cash or property other than stock. The proposal provides answers to these two issues by applying a "wait and see" approach, that is, OID on a LYON is not deductible unless and until the amount of OID is paid in cash. In this way, the proposal defers the determination of whether a LYON is debt or equity until maturity and treats the OID as a contingent interest payment in excess of a reasonably expected yield, which, under present law, generally is not deductible until paid. This approach is consistent with present-law section 163(e)(5) that provides that a portion of the OID of applicable high-yield debt instruments is not deductible until paid.

Opponents of the proposal would argue that the determination of whether an instrument is debt or equity should be made at its issuance and, at issuance, a LYON has more debt-like features than equity-like features. They would further point out that the holder of a LYON is guaranteed to receive at maturity at least the amount of the OID and that present law properly allows issuers to accrue such amount over time. Opponents of the proposal also would argue that under present law, taxpayers are allowed deductions when stock is issued for deductible expenses (or taxpayers can issue stock to the public and use the cash to pay deductible expenses) and that the issuance of stock for accrued interest is no different. They further claim that issuers can achieve results that are similar (or better) than the present law treatment of a LYON by issuing callable OID indebtedness and options or warrants as separate instruments and that the tax law should not discourage the efficient combination of the two types of instruments. However, if the two instruments truly trade separately, it is not clear that they are economically equivalent to a LYON. Finally, opponents would argue that it is unfair and contrary to the present-law OID rules to require holders of LYONS to accrue OID in income while deferring or denying related OID deductions to issuers. Again, under present law, holders of applicable high-yield debt instruments are required to include OID in income as it accrues, while OID deductions of issuers of such instruments are deferred or denied.

3. Limit dividends-received deduction

a. Reduce dividends-received deduction to 50 percent

Present Law

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

of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

Description of Proposal

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

Effective Date

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

Analysis

The general justification for the dividends received deduction of present law is that corporate earnings are taxed at the level of the corporation that first earns them and should not be subject again to full tax in the hands of other corporate distributees. Nevertheless, in 1987 Congress reduced the dividends received deduction on "portfolio" stock (where the investor owns no more than 20 percent of the issuer) to the present-law 70-percent deduction.

In support of reducing the dividends received deduction for portfolio stock, several arguments have been made. The first is that corporations that are not substantially identical should not obtain tax relief for all investment payments made to one another, just as separate individuals do not receive tax relief if they receive payments from another's after tax income.

Furthermore, it has been argued that, in practice, the present-law system is often not a full double tax system, because investors can eliminate or substantially defer all or a portion of their income from stock appreciation due to corporate earnings, by deferring sales, obtaining a favorable capital gains rate when sales do occur, or holding stock until death in which case no income tax will be paid. Furthermore, it is argued that in many instances the corporation distributing a dividend may not have paid "full" corporate tax on the dividend, due to other tax benefits at the corporate level.

Also, the present dividends-received deduction system does not necessarily work properly to insure one, but no more than one, level of corporate tax on corporate earnings. A system of upward basis adjustments for earnings attributable to a shareholder's ownership, and downward basis adjustments for distributions to such shareholder, such as the system applicable to corporations filing consolidated returns, partnerships, and S corporations, would be needed to properly implement a one-tax system, but such a system would not be administrable for portfolio corporate investors. The present system, because it does not reduce basis for distributed earnings, may lead to unwarranted losses where the earnings distributed to a corporation are in

excess of the corporation's share of earnings that accrued while the corporation held the stock.[10] Although the Code provides a number of safeguards (e.g., sections 246(c) and 1059) to prevent these unwarranted losses, the relatively high dividends received deduction leads to improper results and the constant need to implement legislation to eliminate abuses.

On the other hand, it is argued that further reduction of the dividends received deduction is unjustified, including for portfolio stocks, because of the potential for multiple levels of corporate taxation in addition to the ultimate taxation of such earnings to the individual if they are distributed. It is argued that many corporations paying dividends do in fact pay full corporate tax on their distributed earnings and that multiple levels of taxation are unwarranted.

It is also argued that further reduction of the dividends received deduction would create an incentive for corporations to issue greater amounts of debt, to assure at least one corporate level deduction (the interest deduction). Taxpayers in some regulated industries may be required to limit the amount of debt they issue, thus arguably disadvantaging their appeal to investors if the dividends received deduction is not available on their stock. Also, individual taxpayers who may in the past have established private corporations for investment purposes[11] may now be subject to multiple levels of tax if their holding corporations are not permitted a dividends received deduction for dividends received from other corporations.

In addition, it could be argued that the effective date, applicable to dividends on already issued stock if such dividends are paid or accrued after the 30th day after enactment, might significantly adversely affect the expectations of existing investors.

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[10] As a simplified example, if a corporation buys stock of another corporation for $100, all of which reflects accumulated earnings inside the corporation, and much later receives a dividend of $90, the dividend is eligible for the dividends received deduction. In the case of portfolio stock, the basis of the distributee in the stock is not reduced unless the rules of section 1059, which have limited application depending on the size and timing of the dividend, apply. Because the value of the stock has been reduced to $10 by the extraction of the earnings, there is now a potential for the distributee to obtain a $90 loss on sale of the stock, even though it has received $90 with respect to its $100 investment, and was not fully taxed on that receipt.

[11] Such corporations may not have been liquidated during the period before the effective date of the 1986 provisions taxing corporate liquidations for a number of reasons. For example, the shareholder level taxes that could have resulted from such a liquidation would be minimized if instead the investment corporation stock is held until a step-up in basis occurs at the death of the shareholders.

b. Modify holding period for dividends-received deduction

Present Law

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

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

Description of Proposal

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

Effective Date

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

Analysis

Under present law, dividend paying stocks can be marketed to corporate investors with accompanying attempts to hedge or relieve the holder from risk for most of the holding period of the stock, after the initial holding period has been satisfied. In addition, because of the limited application of section 1059 of the Code requiring basis reduction, many investors whose basis includes a price paid with the expectation of a dividend may be able to sell the stock ultimately at an artificial loss, even though the holder may actually have been relieved of the risk of loss for most of the period it has held the stock.

The proposal is intended to increase the likelihood that a corporate investor actually bear the risk of an investment for significant periods throughout the holding period of an instrument in order to be eligible for the dividends received deduction. Risk is generally a factor in considering whether an investor should be considered as the actual "owner" of property eligible for the tax benefits of ownership.

On the other hand, it is argued that the present law rules are sufficient to prevent pure

short term corporate investments for the purpose of reaping largely tax-free income eligible for the dividends received deduction and creating potential artificial losses, since the investor must hold the instrument at risk for at least one dividend period. It may also be argued that risk should not be a factor in determining eligibility for the dividends received deduction, but only the presence of a payment to a corporation, which does occur in the case of dividends paid to hedged corporate holders.

c. Deny dividends-received deduction for preferred stock with certain non-stock characteristics

Present Law

A corporate taxpayer is entitled to a deduction of 70 percent of the dividends it receives from a domestic corporation. The percentage deduction is generally increased to 80 percent if the taxpayer owns at least 20 percent (by vote and value) of the stock of the dividend-paying corporation, and to 100 percent for "qualifying dividends," which generally are from members of the same affiliated group as the taxpayer.

The dividends-received deduction is disallowed unless the taxpayer satisfies a 46-day holding period for the stock (or a 91-day period for certain preferred stock). The holding period generally does not include any period during which the taxpayer has a right or obligation to sell the stock, or is otherwise protected from the risk of loss otherwise inherent in the ownership of an equity interest. If an instrument was treated as stock for tax purposes, but provided for payment of a fixed amount on a specified maturity date and afforded holders the rights of creditors to enforce such payment, the Internal Revenue Service has ruled that no dividends-received deduction would be allowed for distributions on the instrument.[12]

Description of Proposal

Except in the case of "qualifying dividends," the dividends-received deduction would be eliminated for dividends on limited term preferred stock. For this purpose, preferred stock includes only stock that is limited and preferred as to dividends and that does not participate (through a conversion privilege or otherwise) in corporate growth to any significant extent. Stock is only treated as having a limited term if: (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock; (2) the holder 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 similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction rate stock).

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[12] See Rev. Rul. 94-28, 1994-1 C.B. 86.

For this purpose, clauses (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the issue date and is not subject to a contingency which, as of the issue date, makes the likelihood of the redemption or purchase remote.

No inference regarding the present-law tax treatment of the above-described stock is intended by this proposal.

Effective Date

The proposal would apply to dividends on stock issued after the 30th day after the date of enactment of the provision.

Analysis

This proposal extends the denial of the dividends-received deduction to the types of preferred stock that would also be affected under the separate proposal to treat receipt of certain preferred stock as receipt of taxable consideration (or "boot") in certain otherwise non-taxable corporate reorganizations and restructurings.

It is arguable that stock with the particular characteristics identified in the proposal is sufficiently free from risk and from participation in corporate growth that is should be treated as debt for certain purposes, including denial of the dividends received deduction. Many of the types of stock described in the proposal are traditionally marketed to corporate investors (or can be tailored or designed for corporate investors) to take advantage of the dividends received deduction. As one example, a corporation may structure a disposition of a subsidiary in a tax-free transaction, taking back this type of preferred stock. Not only would the transferor escape current tax on receipt of the preferred stock, it can also transform what may be essentially sales proceeds into deductible dividends, based on the future earnings of the corporation after principal ownership has been transferred to others. Features such as puts and calls effectively determine the period within which total payment is expected to occur.

Similarly, so called "auction rate" preferred stock has a mechanism to reset the dividend rate on the stock so that it tracks changes in interest rates over the term of the instrument, thus diminishing any risk that the "principal" amount of the stock would change if interest rates changed. Although it is theoretically possible (and it has sometimes occurred) that an auction will "fail" (i.e., that a dividend rate will not be achieved in the auction that maintains the full value of principal of the investment), this has occurred extremely rarely in actual practice; and investors may view such stock as similar to a floating rate debt instrument.

The Code in various places treated certain non-participating preferred stock differently from other stock. For example, preferred stock that does not participate to any significant extent in corporate growth does not count as stock ownership in determining whether two corporations are sufficiently related to file consolidated returns; also such stock does not count in determining whether there has been a change of ownership that would trigger the loss limitation rules of Code

section 382. This proposal identifies additional features that would lead to denial of the dividends received deduction.[13]

On the other hand, some argue that a relatively low level of risk and participation in growth, or expectation of termination of the instrument at a particular time, should not be factors governing the availability of the dividends received deduction. Furthermore, it is argued that if this type of instrument is viewed as sufficiently debt-like, then it should be classified as debt for all tax purposes, rather than merely subjected to several detrimental non-stock consequences.

4. 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.[14]

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

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[13] See discussion of the related proposal to treat stock with the characteristics described as taxable consideration if received in certain otherwise tax-free corporate reorganizations or restructurings.

[14] 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.

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.[15]

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

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[15] 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.

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 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. 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)[16]). 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 the date of first committee action.

Analysis

In general

The Administration proposal is based on acceptance of the premise that money is fungible and, accordingly, all debt of the taxpayer and its related entities finances its proportionate share of all of the taxpayer's assets, including tax-exempt bonds.

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[16] 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 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)).

Limitations to 2-percent de minimis exception

The Administration proposal would adopt a pro rata rule that would repeal the 2-percent de minimis exception. Some proponents of the Administration proposal accept the premise that money is fungible and, accordingly, would disallow interest deductions on a pro rata basis (e.g., in the same proportion as the taxpayer's average basis in its tax-exempt obligations bears to the average basis of its total assets). These proponents note that the amount of tax arbitrage from the use of additional borrowings to purchase tax-exempt bonds is often the greatest in the case of long-term debt because the yields on long-term tax-exempt debt are higher relative to short-term tax-exempt debt. In addition, these proponents argue that permitting the holding of tax-exempt obligations without limiting the deductibility of interest expense under the 2-percent de minimis exception may be viewed as a tax subsidy which may create a competitive advantage for large taxpayers over taxpayers who (1) are either smaller in size or (2) only provide financing for State and local governments to purchase equipment. These proponents argue that the proposed pro rata allocation of indebtedness among assets (in the manner prescribed for financial institutions) has the additional administrative benefit, for taxpayer's that own more tax exempt bonds than the 2 percent de minimis amount, of avoiding the difficult and often subjective inquiry of when indebtedness is incurred or continued to purchase or carry tax-exempt obligations.

The proponents of the Administration proposal accept that the application of the pro rata rule still could be overridden by other policy concerns in certain circumstances. Accordingly, they accept the retention of the present exception for debt arising from installment sales to State and local governments because such debt often is incurred by governments for acquisition of property that could not easily be financed through debt issued in the public debt markets because of the size of the government or the asset acquisition. In addition, the exception for installment debt is viewed as not as abusive as the general 2-percent de minimis rule because the maturity of installment debt generally is shorter than publicly-traded debt. The exemption from the pro rata rule for insurance companies is justified on the grounds that present law already adjusts the deduction for additions to an insurance company's reserves for its tax-exempt income.

On the other hand, opponents of the Administration proposal argue that the proposal would have the effect of raising the financing costs for a State or local government. Opponents also note that the de minimis exception avoids the complexity of complying with the proposed pro rata rule. Lastly, opponents note that there is no policy justification for repealing the de minimis except for corporations, but not individuals.

Limitation based on all borrowings of related persons

Economically, consistent with the basic premise of the Administration proposal that money is fungible, how the holdings of tax-exempt obligations are financed is unaffected by whether those tax-exempt obligations are held by the same entity that did the borrowing that was the source of financing of those obligations or by a related party. The exclusion of insurance companies from the related group presumably was premised upon the assumption that some State rules applicable to insurance companies prevent the lending to, or the borrowing from,

corporations related to the insurance company and, in such circumstances, the assumption that money is fungible is not valid as to transfers between such insurance company and other related companies.

On the other hand, opponents of the Administration proposal argue that allocating tax-exempt obligations among related entities in proportion to tax-exempt obligations held may have the effect of denying interest deductions on indebtedness where the deductions would not be denied if the taxpayer purchased a tax-exempt obligation for cash simply because that taxpayer is related to another related taxpayer who borrowed money for purposes other than acquiring tax-exempt obligations. In the case of related corporations that do not file a consolidated return, the use of a required tracing rule may be difficult to administer.

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

Present Law

A taxpayer generally recognizes gain or loss on the sale of property measured by the difference between the amount realized on the disposition and the taxpayer's adjusted basis in the property. The gain or loss may be treated as long-term capital gain or loss depending upon the character and holding period of the property.

Under Treasury regulations, if a taxpayer sells a portion of his holdings in stocks or bonds, the taxpayer is allowed to identify the securities disposed of for purposes of determining gain or loss on the disposition. If the stock or bonds sold cannot be adequately identified, the taxpayer is generally deemed to have disposed of the securities first acquired. In general, for identification purposes, the stock or bond certificates actually delivered to the transferee are treated as the stock sold. However, the regulations contain special rules for stock or bonds left in the custody of a broker or other agent. In this situation, adequate identification is made if (1) at the time of the sale the taxpayer specifies to such broker or other agent the particular stock or bonds to be sold and (2) within a reasonable time thereafter, written confirmation of such specification is provided by the broker or other agent. Special rules are provided for identification of certain "book entry" securities, which are limited to certain transferable Treasury instruments and other U.S. government indebtedness.

Mutual fund investors are allowed to determine the adjusted bases of their shares based on the average cost of all such shares.

Description of Proposal

In the case of substantially identical securities, the basis of the securities would be determined on an average basis. For purposes of determining whether gain or loss on a sale of securities is short- or long-term, a taxpayer disposing of less than all substantially identical securities would be treated as having disposed of the securities first acquired.

For purposes of the proposal, a "security" generally would mean any of the securities described in section 475(c)(2), other than subparagraph (F) thereof, including (1) stock in a corporation; (2) a partnership or beneficial interest in widely held or publicly traded partnership or trust; (3) a note, bond, debenture, or other evidence of indebtedness; (4) certain interest rate, currency, or equity notational principal contracts; or (5) evidence of an interest in, or a derivative financial instrument in, any security described above. The proposal generally would not apply to contractual financial products, such as over-the-counter options, notional principal contracts, or forward contracts because a taxpayer generally would not have multiple contracts that are substantially identical.

The Secretary of the Treasury would be given authority to provide, by regulation, that the average basis rule would not apply to certain substantially identical securities if such securities have a special status under a Code provision. For example, regulations could provide that the basis of shares of stock contributed to a partnership (and subject to Code section 704(c)) would not be averaged with the basis of substantially identical shares of stock purchased by the partnership.

Effective Date

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

Analysis

The major advantage claimed by proponents of the proposal is to eliminate the ability of a taxpayer under present law to reduce recognized gains, and increase recognized losses, by identifying the highest basis securities in the portfolio as those sold. Substantially identical securities have the same market value and, thus, a taxpayer is indifferent to which particular securities are sold. The average cost basis proposal thus reflects economic reality by causing the taxpayer to recognize the same amount of gain no matter which securities are sold.

Present law could be viewed as outdated because the Treasury regulation governing identification of securities sold was written principally to cover securities in the form of certificates, whereas the vast majority of stock and securities transactions now occur by computerized book entry. It may even be impossible for some taxpayers to specifically identify securities under the regulation because some brokers' entry systems do not identify the particular securities of a given issue in a taxpayer's account. Such a system makes it impossible for the taxpayer to specify to a broker the particular securities to be sold. Because of the difficulty or even impossibility of complying with the Treasury regulation, it is suspected that many taxpayers take the position that they have sold their highest basis securities when they have not complied with the regulation's requirements for specific identification.

Some have seen the complexity of the proposal as a disadvantage. The difference between the average cost basis rule for determining the amount of gain and the first-in-first-out rule for determining whether such gain is long-term or short-term is likely to cause confusion to

some taxpayers. In addition, the interaction of these two rules may in some circumstances convert gain (or loss) that as an economic matter is long-term into short-term gain (or loss).

Another disadvantage to the proposal might be the amount of recordkeeping involved. Because average basis must be determined each time a taxpayer sells securities, he would have to access records as to the basis of each substantially identical security as well as compute the average. As under present law, the proposal would not require brokers to report basis information to taxpayers. Information retained with respect to one brokerage account would be insufficient to determine average basis if the taxpayer had substantially identical securities in a different brokerage account. Some of the information necessary to compute average basis may be difficult to obtain because the taxpayer may have purchased the securities several years ago, may have inherited them, or may have received them by gift, or in a stock dividend or split, or through a dividend reinvestment plan. The amount of information necessary to determine average basis is not, however, in excess of that required under present law to determine gain when all of a taxpayer's shares are sold because the basis of each share must then be determined. Another criticism that might be made of the proposal is the difficulty of defining "substantially identical" securities.

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

Present Law

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

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

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

Code provides rules only to prevent taxpayers from using short sales against the box to accelerate loss or to convert short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss.

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

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

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

Description of Proposal

The proposal would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in either stock, a debt instrument, or a partnership interest. A taxpayer would be treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain limited circumstances, a person related to the taxpayer) substantially eliminates risk of loss and opportunity for gain by entering into one or more positions with respect to the same or substantially identical property. For example, a taxpayer that holds appreciated stock and enters into a short position with respect to that stock would recognize any gain on the stock. An equity swap with regard to the stock that substantially eliminates risk of loss and opportunity for gain would also be subject to provision. Similarly, a taxpayer that holds appreciated stock and grants a call option or enters into a put option on the stock would generally recognize gain on the stock if there is a substantial certainty that the option will be exercised. In addition, a taxpayer would recognize gain on an appreciated position in stock, debt or partnership interests if the taxpayer enters into a transaction that is marketed or sold as substantially eliminating the risk of loss and opportunity for gain, regardless of whether the transaction involves the same or substantially identical property.

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

period of such position would begin as if the taxpayer had acquired the position on the date of the constructive sale.

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

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

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

A person would be considered related to another for purposes of the proposal if the relationship was one described in 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 the appreciated financial positions held by the taxpayer, the proposal would apply to such positions in the order in which acquired or entered into. If the taxpayer actually disposed of a position previously constructively sold, the offsetting positions creating the constructive sale still held by the taxpayer would be treated as causing a new constructive sale of appreciated positions in substantially identical property, if any, the taxpayer holds at that time.

The application of this proposal would be affected by the separate proposal described above that would require a computation of average cost basis and a FIFO ordering rule for substantially identical securities. For example, the average cost/FIFO proposal would affect the ability of a taxpayer under present law to defer gain under a typical short-against-the-box transaction (i.e., where a taxpayer with appreciated securities borrows identical securities, currently sells the borrowed securities, and later delivers the appreciated securities or other identical securities to close out the borrowing). Under the average cost/FIFO proposal, the taxpayer would be deemed to have sold his appreciated securities, thus recognizing gain.

Effective Date

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

which is 30 days after the date of enactment.

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

Analysis

Generally, gain is recognized on the disposition of property for an amount in excess of its basis. If a taxpayer wishes to dispose of the risk of gain or loss on an investment for any period of time, one possibility would be to sell the investment, and later reinvest. A sale of appreciated property would cause the recognition of gain for tax purposes. However, certain transactions involve the disposition of economic risks and rewards of ownership, at least for certain periods of time, without the recognition of gain for tax purposes.

One frequently-cited example covered by the proposal is the so-called "short sale against the box." This transaction permits a taxpayer to dispose of all risks and rewards of the ownership of stock for a period of time, without immediate gain recognition.[17] Gain is recognized only when stock is delivered to "close" the sale. If the stock used to close the sale is not the underlying stock, but other stock purchased in the marketplace with a higher basis, then under present law there would be no sale of the underlying stock, even though risk of gain and loss had been completely eliminated for a period of time.[18]

In this transaction, a taxpayer that owns appreciated stock sells (through a broker) identical stock that is borrowed from another person, promising to deliver equivalent stock to the lender when the lender requires. The transaction is typically executed through a broker, and many different potential lenders may be available through that broker. Depending on the amount retained by the broker as collateral and whether the shareholder posts the shares that are owned as collateral, most of the cash proceeds may be immediately available to the short-seller, who

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[17] It has been stated: "A short-against-the-box is a pure creature of tax law: in the absence of the tax deferral opportunity afforded by the transaction, there would be no reason to enter a short-against-the-box." Kleinbard, "Risky and Riskless Positions in Securities," *Taxes* at 783 at 790 (December 1993).

[18] To the extent the taxpayer uses funds to purchase other stock to close the transaction, the taxpayer may not "net" any proceeds from the short sale; however, the taxpayer has still been relieved of risk of both gain and loss for a period of time.

can withdraw them from his account. In return, the taxpayer is obligated to transfer stock (either the stock the taxpayer owns "in the box" or other identical stock) when the lender requires. Because the taxpayer already owns stock with which the short sale could be closed, the taxpayer has no risk with respect either to the short position or the "long" position in the stock he continues to hold. However, the taxpayer can receive most of the value (generally, up to 95 percent) of the stock at the time of the short sale. The taxpayer remains obligated to deliver an equivalent amount of stock to close the short sale; thus, the taxpayer might choose to reinvest some or all of the proceeds in stock to be delivered. However, since the taxpayer owns underlying stock in the amount required to be delivered, the taxpayer could choose to use that stock to close the transaction, without an additional purchase (though, under present law, use of the underlying stock at that time would trigger the taxable gain on the underlying stock). The broker charges a lending fee to the client for the stock borrowing. The client may receive payments representing earnings on the amount retained by the broker as collateral, which may be netted with the broker's fees.

Certain individual taxpayers have been reported to be able to arrange for very long periods of deferral (perhaps even until death) with virtually no fees, through advantageous relationships (e.g., family member relationships) with the persons who are the "lenders" of the stock that is sold, in effect permitting deferral until the death of the short-seller, at which time the step-up in basis of the underlying stock would eliminate any income tax even if the stock held "in the box" is then used to close the short sale.[19]

When the underlying stock (i.e., the stock "in the box") is used to close the transaction, the gain from the difference between the basis of that stock and the proceeds received earlier will be recognized. However, if the stock would have a very large amount of taxable gain due to a low basis, there can be circumstances where it would be advantageous to close the sale with other stock, such as stock purchased for the purpose of closing the sale.

Some short sales remain open for a relatively short period of time--e.g., to hedge against potential loss in case of upcoming earnings announcements or for against other short-term risks, even though the taxpayer has a long-term investment objective to continue holding the stock. It is arguable that a short sale that is closed using the underlying stock within the taxable year has not resulted in significant tax deferral and need not be taxed at the time of the sale.

On the other hand, it is arguable that one way to lock in value in the same amount as the short sale, even for a short period of time, is to sell the underlying stock directly, and repurchase new stock later if desired, after the period of undesirable risk has passed. Such an alternative would require payment of tax on the gain, even if the stock were repurchased very shortly thereafter and within the taxable year.

In addition to the "short sale against the box," there are other transactions that can relieve

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[19] See, e.g., Sloan, "Passing the Smell Test?" *Newsweek*, p.57 (December 4, 1995).

the taxpayer of the risk of loss and the opportunity for gain on an investment for at least some period of time. Another example is the so called "whole equity swap." In this transaction, the taxpayer contracts with another party (usually through a broker or other middleman) that owns property in which the taxpayer would like to invest. Under the contract, for a period of time one party ("A"), who owns stock of company X, contracts with another party ("B"), who owns stock of company Y deemed to be of equivalent value (the "notional" amount of the investment), as follows: A will pay to B periodically an amount equal to any dividends on A's stock, plus the amount of any increases in value of A's stock over the notional amount at the time of the contract, plus the amount of any decreases in the value of B's stock below the nominal amount; and B will pay to A the same, with respect to the increases in value of B's stock as compared with the notional amount and the decreases in the value of A's stock below the notional amount. In effect, for the period of the contract, A has invested the entire value of its X stock in the Y stock owned by B, and vice versa. The transaction arguably differs from an outright sale in that it is a reinvestment for a limited period of time, and is subject to the credit risk of the other party. However, as in the case of the short sale, an equivalent transaction would have been to sell the underlying stock, pay tax, and reinvest the proceeds in the other stock, with a subsequent sale and repurchase at a later time if desired. Furthermore, some outright sales may involve a credit risk of the purchaser. .

The proposal to cause immediate gain recognition has been criticized for lack of certainty, in that gain recognition would only be triggered if the taxpayer has disposed of "substantially all" the upside and downside risk of the transaction for any period of time. Many types of contracts, for example involving "caps" and "collars", eliminate some but not all of the upside or downside risk (or both) with respect to an investment. Thus, for example, instead of contracting to reimburse one another for the whole amount of various changes in value, as under the whole equity swap, parties may contract to reimburse one another (or may enter puts and calls with similar effect) for changes in value within a specified range, but not beyond that range.

While a short against the box transaction is specifically covered by the proposal since it is regarded as a case where all of the upside and downside risk has been removed for a period of time, it is argued that the term "substantially all"of the risk of loss and opportunity for gain is unclear in other contexts, such as swaps or similar arrangements in which transactions can be entered where less than all upside or downside risk is hedged. For example, if one stock is volatile and another is very stable, disposition of the same proportionate amount of upside and downside risk may be disposition of "substantially all" the risk in one case but not in the other. It is argued that such uncertain analyses should not be the basis for required gain recognition.

Similarly, if the taxpayer enters into a put or call with respect to appreciated stock, the taxpayer would be subject to the proposal if there is a "substantial likelihood" the put or call would be exercised. "Substantial likelihood" is not defined in the proposal.

It is arguable that such transactions may not be entered into without an understanding of the investment objectives by each of the parties, including an understanding of the amount of

risk to be shifted. However, there may still be uncertainty as to whether the proposal would apply because "substantial" risk was shifted.

It is also argued that, except for the case of the short against the box transaction, the provision may be avoided through the crafting of instruments that dispose of somewhat less than "substantially all" of both the upside and downside risk. Thus, it is argued, the short against the box transaction, which may be available for relatively low cost compared to other transactions, would be taxed, while some investors with access to more sophisticated financial arrangements may still avoid tax under the proposal. On the other hand, it is argued that small investors may not be able to obtain the lowest costs of the short against the box transaction; thus, for such investors, the transaction may not make sense, or may be useful only for very short term elimination of risk. Furthermore, for the larger investor, use of other techniques will involve a higher price in the form of higher transaction casts and the undesired risks they are retaining, and that these costs may deter some types of transactions. Nevertheless, it may be argued that sophisticated investors would pay such a price if it is, in the aggregate, less than the tax cost of an actual sale.

Finally, some would criticize the effective date of the proposal. First, the proposal would apply to transaction entered into after January 12, 1996, unless unwound 30 days after enactment of the proposal. Some would view such an effective date as retroactive. In addition, there is an argument that the effective date for transactions involving decedents who die after date of enactment without unwinding the transaction is too harsh. The argument is that it may become too expensive to close out the transaction and return to a non-sale position, without gain recognition, because this will require a purchase of stock on the market and the value of the stock may have gone up since the transaction was entered. On the other hand, it is argued that at least in cases where the transactions were entered with related parties (such as family members) market cost considerations might possibly be less significant than in other cases.

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

Present Law

Treatment of gains and losses

Gain from the "sale or other disposition" is the excess of the amount realized therefrom over its adjusted basis; loss is the excess of adjusted basis over the amount realized. The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset.[20] It is possible for there to be a taxable income from the disposition of an asset

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[20] Code section 1221 defines a capital asset to mean property held by the taxpayer other than (1) property properly includible in inventory of the taxpayer or primarily held for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable and real property used in the taxpayer's trade or business, (3) a copyright, a literary musical; or artistic

without that gain being treated as a capital gain.[21]

Treatment of capital gains and losses

Long-term capital gains of individuals are subject to a maximum rate of tax of 28 percent. Capital losses of individuals are allowed to the extent of capital gains plus $3,000. Excess capital losses are carried forward to succeeding years for an unlimited period.

Long-term capital gains of corporations are subject to the same rate of tax as ordinary income. Capital losses of corporations are allowed only to the extent of the corporation's capital gains; excess capital losses may be carried back to the 3 preceding years and carried forward for the 5 succeeding years.

In the case of gains and losses from the sale or exchange of property used in a trade or business, net gains generally are treated as capital gain while net losses are treated as ordinary losses.

Extinguishment treated as sale or exchange

The Internal Revenue Code contains several provisions that deem certain transactions to be a sale or exchange. These rules generally provide for "sale or exchange" treatment as necessary to extending treatment of those transactions as capital gains and losses.

Under one of these special provisions, gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to certain personal property are treated as gains or losses from the sale of a capital asset (sec. 1234A). The personal property subject to this rule is (1) personal property (other than stock) of a type which is actively traded and which is, or would be on acquisition, a capital asset in the hands of the taxpayer[22] and

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composition, letter or memorandum, or similar property that was created by the taxpayer (or whose basis is determined, in whole or in part, the basis of the creator, (4) accounts or notes receivable acquired in the ordinary course of the taxpayer's trade or business, and (5) a publication of the United States Government which was received from the Government other than by sale.

[21] The U.S. Supreme Court has held that the term "sale or exchange" is a narrower term than "sale or other disposition." Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941).

[22] Treasury regulations generally define "actively traded" as any personal property for which there an established financial market. In addition, those regulations provide that a "notional principal contract constitutes personal property of a type that is actively traded if contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on an established financial market" and that "rights and obligations of a party to a

(2) a "section 1256 contract"[23] which is a capital asset in the hands of the taxpayer.[24] Section 1234A does not apply to the retirement of a debt instrument.

There has been a considerable amount of litigation dealing with whether a modification of legal relationships between taxpayers is treated as a "sale or exchange." Several court decisions interpreted the "sale or exchange" requirement to mean that a disposition which occurs as a result of a lapse, cancellation or abandonment is not a sale or exchange of a capital asset and, consequently, the disposition produces ordinary income or loss. For example, in Commissioner v. Pittston Co., 252 F. 2d 344 (2d Cir.). cert. denied, 357 U.S. 919 (1958), the taxpayer was treated as receiving ordinary income from amounts received for acquisition from the mine owner of a contract that the taxpayer had made with mine owner to buy all of the coal mined by that mine owner at a particular mine for a period of 10 years on the grounds that the payments were in lieu of subsequent profits that would have been taxed as ordinary income. Similarly, in Commissioner v. Starr Brothers, 205 F. 2d 673 (2d Cir. 1953), the Second Circuit held that a payment that a retail distributor received from a manufacturer in exchange for waiving a contract provision prohibiting the manufacturer from selling to the distributor's competition was not a "sale or exchange". Likewise, in General Artists Corp. v Commissioner, 205 F. 2d 360 (2d Cir. 1953), cert. denied 346 U.S. 866 (1953), the Second Circuit held that amounts received by a booking agent for cancellation of contract to be the exclusive agent of a singer was not a "sale or exchange." In National-Standard Company v. Commissioner, 749 F. 2d 369 (6th Cir. 1984), the Sixth Circuit held that a loss incurred upon the transfer of foreign currency to discharge the taxpayer's liability was an ordinary loss, since transfer was not a "sale or exchange" of that currency. More recently, in Stoller v. Commissioner, 994 F. 2d 855, 93-1 U.S.T.C. par. 50349 (1993), the Court of Appeals for the District of Columbia held, in a transaction that preceded the effective date of section 1234A, that losses incurred on the cancellation of forward contracts to buy and sell short-term Government securities that formed a straddle were ordinary because the cancellation of the contracts was not a "sale or exchange."

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notional principal contract are rights and obligations with respect to personal property and constitute an interest is personal property." Treas. reg. sec. 1.092(d)-1(c).

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

[24] The present law provision (sec. 1234A) which treats cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property as a sale of a capital asset was added by Congress in 1981 when Congress adopted a number of provisions dealing with tax straddles. Since straddles were the focus the 1981 legislation, that legislation was limited to types of property which typically were the subject of straddles, i.e., personal property (other than stock) of a type which is actively traded which is, or would be on acquisition, a capital asset in the hands of the taxpayer. The provision subsequently was extended to section 1256 contracts.

Retirement of debt obligations treated as sale or exchange

Amounts received on the retirement of any debt instrument are treated as amounts received in exchange therefor (sec. 1271(a)(1)). In addition, gain on the sale or exchange of a debt instrument with OID[25] 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.[26] The tax treatment of retirement of debt obligations covered by these exceptions is governed by case law which held that gain realized on the redemption of bonds before their maturity is not entitled to capital gain treatment because the redemption was not a "sale or exchange."[27]

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 with respect to property described above to rights and obligations in all types of property which is (or on acquisition would be) a capital asset in the hands of the taxpayer.

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,

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[25] 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 basis. Among other exceptions, the mandatory inclusion of OID in income does not apply 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)).

[26] In addition to the rule in section 1271(a)(1) that treats the retirement of a debt obligation as an exchange, these two exceptions also apply to a rule which treats gain realized on the sale or exchange of a debt instrument where there is an intention to call before maturity as ordinary income (sec. 1271(a)(2)) and a rule which treats gain realized on the sale or exchange of short-term (i.e., maturity less than one year) nongovernment obligations as ordinary income to the extent of the obligation's ratable share of original issue discount (sec. 1271(a)(3)).

[27] Douglass Fairbanks v. U.S., 306 U.S. 436 (1939). The result in this case was overturned by enactment in 1934 of the predecessor of present-law section 1271(a). (See sec. 117 of the Revenue Act of 1934, 28 Stat. 680, 714-715.)

under the proposal, gain or loss on the retirement of such debt generally will be capital gain or loss. The proposal would retain the present-law exceptions for debt issued before July 2, 1982, by noncorporate or nongovernmental entities.[28]

Effective Date

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

Analysis

Extinguishment treated as sale or exchange

Some transactions, such as settlement of a contract to deliver a capital asset, are economically equivalent to a sale or exchange of that contract. However, some courts have held that transactions which terminate contractual interests are not treated as a "sale or exchange."

The fact that some modifications of property rights are not treated as a sale or exchange under present law effectively gives taxpayers an election, in many cases, to treat the transaction as giving rise to capital gain, subject to more favorable rates than ordinary income, or an ordinary loss that can offset higher-taxed ordinary income and not subject to the limitations on use of capital losses. The effect of an election can be achieved by selling the property right if the transaction results in a gain or providing for the extinguishment of the property right if the transaction results in a loss. Thus, the major effect of the Administration's proposal would be to remove the ability to effectively elect the character of a transaction that is not presently covered by section 1234A by treating the cancellation, lapse, expiration, or other termination of a right or obligation with respect to all types of property which is (or on acquisition would be) a capital asset in the hands of the taxpayer as a "sale or exchange." One subsidiary effect of the Administration proposal would be to reduce the uncertainty concerning the tax treatment of modifications of property rights.

By definition, the extension of the "sale or exchange" rule of present law section 1234A to all property will only affect property that is not personal property which is actively traded on an established exchange. This will include (1) interests in real (i.e., non-personal) property and (2) non-actively traded personal property. An example of the first type of property interest that will be affected by the Administration's proposal would be the tax treatment of amounts received

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[28] The proposal also would retain the rule which treats gain realized on the sale or exchange of a debt instrument where there is an intention to call before maturity as ordinary income (sec. 1271(a)(2)) and the rule which treats gain realized on the sale or exchange of short-term (i.e., maturity less than one year) nongovernment obligations as ordinary income to the extent of the obligation's ratable share of original issue discount (sec. 1271(a)(4)).

to release a lessee from a requirement that the premise be restored on termination of the lease.[29] An example of the second type of property interest that would be affected by the Administration's proposal would be the forfeiture of a down payment under a contract to purchase stock.[30] The Administration proposal is unclear whether "cancellation, lapse, expiration or other termination of any right or obligation with respect to property" covers abandonment of rights in property. The Administration proposal would not affect whether a right is "property"[31] or whether property is a "capital asset."[32]

Character of gain on retirement of debt obligations issued by natural persons

Since section 1271(b)(1) exempts obligations issued by natural persons from the deemed "exchange" on retirement rule, the character of gain or loss realized on retirement of such an obligation under present law generally is noncapital (i.e., ordinary) gain or loss under present law.[33] The Administration proposal would change the treatment of gains and losses on such retirements to capital gain or loss by treating such retirements as an "exchange." Examples of where the Administration proposal would apply would be a loss incurred by a mortgagee upon foreclosure of the mortgage of an individual,[34] or a loss incurred on a compromise to settle mortgage notes.[35]

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[29] See Billy Rose Diamond Horseshoe, Inc. v. Commissioner, 448 F. 2d 549 (2d Cir. 1971), holding that payments were not entitled to capital gain treatment because there was no sale or exchange. See also, Sirbo Holdings, Inc. v. Commissioner, 509 F.2d 1220 (2d Cir. 1975).

[30] See U.S. Freight Co. v. U.S., 422 F.2d 887 (Ct. Cl. 1970), holding that forfeiture was an ordinary loss.

[31] See, e.g., Anderson v. U.S., 468 F. Supp. 1085 (D.C. Minn. 1979); Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130 (1960).

[32] See, e.g., Hort v. Commissioner, 313 U.S. 38 (1941) and Commissioner v. P.G. Lake, 356 U.S. 260 (1958).

[33] See Fairbanks, op. cit. But see, sect. 582(c), which treats the sale of a bond, debenture, note, or certificate or other evidence of indebtedness by a financial institution not being a sale or exchange of a capital asset.

[34] See Wenger v. Commissioner, 4 B.T.A. 225 (1940), aff'd 127 F. 2d 523 (6th Cir. 1942), cert. denied, 317 U.S. 656 (1942).

[35] See, e.g., Hale v. Helvering, 85 F. 2d 819 (D.C. Cir. 1936).

8. 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 the "all events" test of present law, the holder of the indebtedness is not required to accrue interest until after the specified date has passed. The "all events" test provides that the taxpayer need not include income in gross income until all the events have occurred that fix the taxpayer's right to receive such income and the amount can be determined with reasonable accuracy. [36]

Original issue discount

The holder of a debt instrument with original issue discount ("OID") generally accrues and incudes 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

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[36] Treas. reg. sec. 1.451-1(a).

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, 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.

The proposal is not intended to apply to pools of receivables for which interest charges are incidental. Thus, for example, it is intended that the proposal would not apply to a merchant that (1) permits customers to pay their bills within a reasonable time and (2) does not routinely receive interest from a substantial portion of its customers. 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.

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.

Analysis

In general, in order to more accurately measure income, interest should be accruable over time, beginning with the date the underlying obligation arose and ending with the date the obligation is satisfied. The proposal raises issues of the proper measurement of income and whether interest income should be accrued before it is legally or contractually "earned."

As stated above, the "all events" test provides that the taxpayer need not include income in gross income until all the events have occurred that fix the taxpayer's right to receive such income and the amount can be determined with reasonable accuracy. With respect to a large pool of credit card receivables that do not charge interest until after a grace period, only one prong of the "all events" test is satisfied. That is, although the taxpayer does not have fixed right to receive any interest income (because all credit card holders may pay their individual balances before the end of the grace period), the amount of interest the taxpayer is likely to receive is determinable with reasonable accuracy (because it unlikely that all credit card holders will prepay their accounts and the taxpayer's prior experience would dictate the portion likely to prepay). In this respect, the proposal may lead to a better measurement of income even if it is a violation of the current "all events" test.

Present law already recognizes the fact that taxpayers are able to accurately measure interest income with respect to a pool of indebtedness without regard to the "all events" test. Section 1272(a)(6) provides that taxpayers must make prepayment assumptions with respect to regular interests in a REMIC or qualified mortgages held by the REMIC. Some would argue that pools of receivables are economically similar to pools of mortgages held by a REMIC and should be treated similarly for tax purposes.

The proposal is premised on the assumption that it is statistically feasible to determine an appropriate amount interest income to be accrued on a large pool of indebtedness subject to prepayment. Taxpayers may question why such assumptions are used for purposes of accruing income, but not deductions. For example, a taxpayer is not allowed to claim a bad debt deduction until such time as the debt becomes wholly or partially worthless. Worthlessness generally must be demonstrated by the taxpayer and can be evidenced by showing that an insolvent debtor has not timely serviced a debt and has refused to make payments in the future, has gone through bankruptcy, or has disappeared. In the case of a large pool of receivables, worthlessness must be determined on an account-by-account basis. A taxpayer may claim that it should be allowed to determine its bad debt deductions with respect to such pool based on reasonable assumptions, in a manner similar to the use of such assumptions under the proposal. However, the there are differences between the accrual of interest income under the proposal and the accrual of bad debts. First, the proposal generally would require the accrual of income for which the "all events" test often will be met soon after yearend (and before the taxpayer is required to file its tax return for the year of accrual). A debt may not become worthless until some time after yearend. Second, if interest is received by the taxpayer, the interest is properly

allocable over the term of the obligation. Worthlessness of a debt may be caused by an event that occurs some time after the obligation is created (e.g., the subsequent unemployment of the creditor).

B. Corporate Tax Provisions

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.[37] Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.[38]

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

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

[38] 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.[39]

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 bill.

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.[40] However, in

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[39] 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.

[40] 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.

Analysis

The provision is identical to a provision included in the Balanced Budget Act of 1995 (H.R. 2491, 104th Cong.), passed by the Congress and vetoed by President Clinton. The proposal contains the same effective dates as the dates contained in that Act.

Under present law, corporate taxpayers have attempted to dispose of stock of other corporations in transactions structured as redemptions, where the redeemed corporate shareholder apparently expects to take the position that the transactions are dividends that qualify for the dividends received deduction. Thus, the redeemed corporate shareholder attempts to exclude from income a substantial portion of the amount received. In some case, it appears that the taxpayers' interpretations of the option attribution rules of section 318(a)(4) are important to the taxpayers' contentions that their interests in the distributing corporation are not meaningfully reduced, and are, therefore, dividends.[41] Some taxpayers may argue that certain options have sufficient economic reality that they should be recognized as stock ownership for purposes of determining whether a taxpayer has substantially reduced its ownership.

Even in the absence of options, the present law rules dealing with extraordinary dividends may permit inappropriate deferral of gain recognition when the portion of the distribution that is excluded due to the dividends received deduction exceeds the basis of the stock with respect to which the extraordinary dividend is received.

Some taxpayers might also contend that the 1995 effective date, even though based on

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[41] For example, it has been reported that Seagram Corporation intends to take the position that the corporate dividends-received deduction will eliminate tax on significant distributions received from DuPont Corporation in a redemption of almost all the DuPont stock held by Seagram, coupled with the issuance of certain rights to reacquire DuPont stock. (See, e.g., Landro and Shapiro, "Hollywood Shuffle," *Wall Street Journal*, pp A1 and A11 (April 7, 1995); Sloan, "For Seagram and DuPont, a Tax Deal that No One Wants to Brandy About," *Washington Post*, p. D3 (April 11, 1995); Sheppard, "Can Seagram Bail Out of DuPont without Capital Gain Tax," *Tax Notes Today*, (April 10, 1995, 95 TNT 75-4).

prior Congressional action, should be modified to reflect more current Congressional action.

2. Repeal percentage depletion for nonfuel minerals mined on Federal lands

Present Law

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

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

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

The Mining Law of 1872 permits U.S. citizens and businesses to freely prospect for hard rock minerals on Federal lands, and allows them to mine the land if an economically recoverable deposit is found. No Federal rents or royalties are imposed upon the sale of the extracted minerals. A prospecting entity may establish a claim to an area that it believes may contain a mineral deposit of value and preserve its right to that claim by paying an annual holding fee of $100 per claim. Once a claimed mineral deposit is determined to be economically recoverable, and at least $500 of development work has been performed, the claim holder may apply for a "patent" to obtain title to the surface and mineral rights. If approved, the claimant can obtain full title to the land for $2.50 or $5.00 per acre.

Description of Proposal

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

Effective Date

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

Analysis

The percentage depletion provisions generally can be viewed as providing an incentive for mineral production. The Mining Act of 1872 also provides incentives for mineral production by allowing claimants to acquire mining rights on Federal lands for less than fair market value. In cases where a taxpayer has obtained mining rights relatively inexpensively under the provisions of the Mining Act of 1872, it can be argued that such taxpayers should not be entitled to the additional benefits of the percentage depletion provisions. However, the Administration proposal would appear to repeal the percentage depletion provisions not only for taxpayers who acquired their mining rights directly from the Federal Government under the Mining Act of 1872, but also for those taxpayers who purchased such rights from a third party who had obtained the rights under the Mining Act of 1872. In cases where mining rights have been transferred to an unrelated party for full value since being acquired from the Federal Government (and before the effective date), there is little rationale for denying the benefits of the percentage depletion provisions to the taxpayer currently mining the property on the basis that the original purchaser obtained benefits under the Mining Act of 1872.[42]

3. 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), excess interest losses (no carrybacks), and net capital losses of corporations (carryforward limited to five years).

Description of Proposal

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

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[42] It is our understanding that the Administration intends to propose a transition rule that would address this problem.

Effective Date

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

Analysis

A taxpayer is required to report taxable income on an annual basis even though the taxpayer's natural business cycle may be longer than one year or may overlap a taxable yearend. Present law generally allows NOLs to be carried back three years and carried forward 15 years in order to smooth out swings in taxable income and loss caused by the annual accounting period requirement.

The lengths of the NOL carryback and carryforward periods have varied over time. The original NOL carryover periods, enacted in 1918, were one year forward and one year back. Subsequent legislation lengthened, shortened, or eliminated the NOL carryback and carryforward periods, often in response to the economic climate of the times. For example, neither carrybacks nor carryforwards were allowed during most of the Depression period of the 1930s. The current three-year NOL carryback period became applicable in 1958; prior law had limited carrybacks to two years. The current 15-year carryforward period was enacted as part of the Economic Recovery Tax Act of 1981; prior law had limited NOL carryforwards to seven years.

Reducing the carryback period would reduce the number of immediate tax refunds. Taxpayers would be required to carry NOLs forward to offset income in future profitable years, thus reducing the present value of the NOL and effectively increasing the tax burden of affected taxpayers. Increasing the carryforward period would provide a benefit to those taxpayers that would otherwise have their NOLs expire. Currently, however, most NOLs do not expire because the 15-year carryforward period is sufficiently long and there are various tax planning opportunities for taxpayers to accelerate taxable income into the 15-year period in order to absorb expiring NOLs.

The taxpayer must file an amended tax return for each year to which an NOL is carried back. The use of an NOL in the carryback year may "free up" tax credits generated and used in such year, requiring further amended returns to carry back the credits to prior years. By further limiting the number of years an NOL may be carried back, the proposal would limit the number of amended tax returns that would be filed, aiding tax administration.

4. 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) apply if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. In addition, a right or obligation would be disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder or, in the case of stock transferred in connection with the performance of services, upon the holder's retirement.

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

the corporation. Shares held by a family member would be treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences still apply.

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

The Treasury Secretary would have regulatory authority to (1) apply installment sale-type rules to preferred stock that is subject to this proposal in appropriate cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., 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 on or after the date of first committee action.

Analysis

The type of stock described in the Administration proposal has been widely used in certain corporate transactions to afford taxpayers non-recognition treatment even though they may receive relatively secure instruments in exchange for relatively risky instruments.

As one example, suppose a corporation wishes to acquire the stock of a corporation for cash, but this would not qualify as a tax-free reorganization to a particular shareholder that does not wish to recognize gain on its stock at that time. Transactions are structured so that a new holding company is formed, to which the shareholder contributes common stock in exchange for a preferred stock. The acquiring corporation contributes cash to the holding company, which uses the cash to acquire the stock of the other shareholders. In the final acquisition structure, the shareholder who received preferred stock also may have the additional benefit that the holding company, in which it now owns preferred stock, may itself own highly secure investments. (Similar results might also be obtained if the corporation recapitalized by issuing the preferred stock in exchange for the common stock of the shareholder). Features such as puts and calls may effectively determine the period within which total payment is expected to occur.

Similarly, so called "auction rate" preferred stock has a mechanism to reset the dividend rate on stock so that it tracks changes in interest rates over the term of the instrument, thus diminishing any risk that the "principal" amount of stock would change if interest rates changed.

Although it is theoretically possible (and it has sometimes occurred) that an auction will "fail" (i.e., that a dividend rate will not be achieved in the auction that maintains the full "principal" value of the investment), this has occurred rarely; and many investors may view such stock as similar to a floating rate debt instrument.

Because the instruments described in the Administration proposal often contain provisions designed to reduce significantly any risk of loss of principal value, or may contain provisions indicating a time certain in the future at which the investment is expected to be terminated, it is arguably appropriate to view such consideration as taxable when received by an investor that formerly held a less secure type of stock.

Arguably, it is not necessary to treat such consideration as debt for all purposes, since the purpose of the proposal is merely to reflect that the investor has significantly upgraded the security of his or her prior investment and thus should not be afforded nonrecognition treatment as if he or she had continued the same type of investment that the investor had before the transaction.

Conversely, it may be argued that it is inappropriate to treat certain instruments as stock for some purposes but remove the benefit of stock treatment for limited purposes. Furthermore, it may be argued that if the types of instruments are considered sufficiently at the risk of the business not to be classified as debt in the past, it is inappropriate to require gain recognition on receipt of such instruments in the future.

The proposal provides an exception for certain transactions involving family-owned corporations. It may be argued that if the proposal represents the proper tax policy, it should be applied to all transactions, regardless of the identity of the shareholders. Others may contend that the exception is desirable to facilitate certain family restructurings, especially in connection with generational transfers of corporate ownership.

Finally, it could be argued that taxpayers may avoid the proposal in many (though not all) cases by various techniques, such as lengthening the term of the instrument to more than 20 years, or providing some element of participation in growth (including through a conversion feature) that avoids the technical requirements of the proposal. Similarly, because the proposal does not affect stock that is redeemable only upon the death of the holder, certain transactions that offer an elderly individual shareholder not only the opportunity for deferral but also for step-up in basis at death would not appear to be affected.

5. Conversion of large corporations into S corporations treated as complete liquidations

Present Law

The income of a corporation described in subchapter C of the Internal Revenue Code (a "C corporation") is subject to corporate-level tax when the income is earned and individual-level tax when the income is distributed. The income of a corporation described in subchapter S of the

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

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

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

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

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

Description of Proposal

The proposal would repeal section 1374 for large S corporations. A C-to-S corporation conversion (whether by a C corporation electing S corporation status or by a C corporation merging into an S corporation) would be treated as a liquidation of the C corporation followed by a contribution of the assets to an S corporation by the recipient shareholders. Thus, the

proposal would require immediate gain recognition by both the corporation (with respect to its appreciated assets) and its shareholders (with respect to their stock) upon the conversion to S corporation status.

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

Effective Date

The proposal generally would be effective for subchapter S elections that become effective for taxable years beginning after January 1, 1998. Thus, C corporations would continue to be permitted to elect S corporation status effective for taxable years beginning in 1997 or on January 1, 1998. The proposal would apply to acquisitions (e.g., the merger of a C corporation into an existing S corporation) after December 31, 1997.

In addition, the Internal Revenue Service would revise Notice 88-19[43] to conform to the proposed amendment to section 1374, with an effective date similar to the statutory proposal. As a result, the conversion of a large C corporation to a regulated investment company ("RIC") or a real estate investment trust ("REIT") after the revisions would result in immediate recognition by the C corporation of the net built-in gain in its assets.

Analysis

The conversion of a C corporation to an S corporation may be viewed as the constructive liquidation of the C corporation because the corporation has changed from taxable status to passthrough status. The proposal would conform the tax treatment of such constructive liquidation to the tax treatment of an actual liquidation. Thus, the proposal would conform the treatment of the conversion from C corporation status to passthrough entity status where the passthrough entity is an S corporation with the present-law treatment where the passthrough entity is a partnership or a sole proprietorship.

The proposal would eliminate some of the complexity of subchapter S under present law. The rules that trace C corporation built-in gain and C corporation earnings and profits generally would become unnecessary. In addition, the rules imposing corporate tax and the possible loss of S corporation status after the conversion due to excessive passive income also could be eliminated. However, these complex rules would continue to apply to small converting C corporations and it could be argued that these businesses are the least able to handle complexity.

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[43] Notice 88-19, 1988-1 C.B. 486, allows C corporations that become RICs or REITs to be subject to rules similar to those of section 1374, rather than being subject to the rules applicable to complete liquidations.

The proposal would create some complexity, as it would require the valuation of C corporation stock to determine if the $5 million threshold has been exceeded and C corporation assets for purposes of determining the amount of gain on the constructive liquidation. However, valuations theoretically are required under present law because of the need to determine whether corporate tax may be due under the built-in gain tracing rules; it is possible that taxpayers may not perform the valuations for all assets in all cases, particularly if they believe that there is no aggregate net built-in gain, or if there is a possibility that built-in gain assets may not be disposed of within the present-law tracing period. It should be noted that the $5 million threshold creates a "cliff" where corporations valued at $5 million or less are not subject to tax while corporations valued at greater than $5 million would be subject to full taxation. It appears that rules would be required to address step transactions designed to avoid the proposal (e.g., where a series of C corporations, each under the $5 million cap, merge into an S corporation; or where a large C corporation divides into multiple entities so that some or all of the entities are under the $5 million cap). Another issue under the proposal is whether the stock of the corporation is to be valued immediately before the conversion (i.e., as C corporation stock subject to two levels of tax) or immediately after the conversion (i.e., as S corporation stock, subject to one level of tax).

The proposal would create significant shareholder and corporate liquidity concerns for large C corporations planning on converting to S corporation status. Current businesses that organized as C corporations may have done so in anticipation of converting at a relatively low tax cost in the future. Not applying the proposal until taxable years beginning after January 1, 1998, addresses some, but not all, of these concerns.

Finally, the proposal raises significant policy issues regarding the integrity of the separate corporation tax as opposed to integrating the corporate and individual tax regimes. More acutely, the proposal raises issues regarding the need for the continued existence of subchapter S in light of other developments. Recent IRS rulings with respect to the various State limited liability companies and the "check-the-box" Treasury regulations[44] have significantly expanded the availability of passthrough tax treatment for entities that accord their investors limited legal liability. These developments, coupled with the restrictive rules of subchapter S,[45] have decreased the desirability of the subchapter S election for newly-formed entities. This proposal would decrease the desirability of the subchapter S election for existing C corporations. Thus, if the proposal were enacted, the primary application of subchapter S would be limited to existing S corporations and small converting corporations. At that point, one may question whether it is desirable to have a whole separate passthrough regime in the Code that pertains to a limited

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[44] Treas. reg. secs. 301.7701-1,-2, and -3, issued in final form on December 17, 1996.

[45] For example, only domestic corporations with simple capital and limited ownership structures may elect to be S corporations.

number of taxpayers. Any repeal of subchapter S would require rules providing for the treatment of existing S corporations.[46]

6. 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.

Description of Proposal

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

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

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[46] See, for example, the letter of July 25, 1995, from Leslie B. Samuels, Assistant Treasury Secretary (Tax Policy) to Senator Orrin Hatch, suggesting possible legislative proposals to allow S corporations to elect partnership status or to apply the check-the-box regulations to S corporations.

distribution it is subject to various conditions, such as the approval of shareholders or a regulatory body.

Effective Date

The proposal would be effective for distributions after the date of first committee action.

Analysis

Present law permits the tax-free acquisition of subsidiary or parent corporations in exchange for the stock of the acquiror. However, in many instances, a potential acquiror may not want to acquire all the businesses of a corporate parent; and may not want the parent to be a shareholder of the acquiror if a subsidiary is acquired in a tax free merger or similar transaction for stock of the acquiror. A frequently used transaction under present law is for a spin-off to occur in connection with an acquisition of one or more (but not all) of the businesses of the parent corporation, so that, in general, old shareholders of the parent retain one or more of the corporate businesses, but receive stock of an acquiror for their interest in the business that is acquired. As described above, such a spin-off can be tax-free under section 355 and the subsequent change in control of the target company can be tax-free under one of the reorganization provisions of section 368.[47]

There also has been considerable publicity regarding particular features of a number of such cases, including situations in which a significant shift in debt occurs in the transaction, such that the business that changes hands retains a greater proportion (to value) of debt than the combined corporate group before the transaction, while the group remaining with the old shareholders obtains a more favorable balance sheet after the transaction.[48] In other cases, the

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[47] See, e.g., *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir 1966); Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 78-251, 1978-1 C.B. 89. In the *Morris Trust* case, a corporation spun off a subsidiary and then merged with another corporation. The old shareholders of distributing received stock in the merged corporation that was more than 50 percent of the ownership of that corporation. Thus, the particular transaction would not have been affected by the Administration proposal, had the proposal been in effect. Had the proportionate sizes of the respective corporations been different, however, the old shareholders could have received less than 50 percent of the stock of the merged corporation, so that the Administration proposal could have applied.

[48] See, e.g., "Viacom Agrees to Spin Off, Then Sell its Cable Systems: Accord Allows the Transfer of $1.7 Billion in Debt; TCI is Ultimate Owner" *Wall Street Journal* (July 26, 1996); "GM or Hughes Could Get Billions in Cash From Sale," *Wall Street Journal* p. B4,(January 8, 1997); "GM Unveils Sale of Hughes Defense Arm to Raytheon Co in $9.5 Billion Accord", *Wall Street Journal*, p.A3, (January 17, 1997); Sloan, "A Sexy New Loophole," *Newsweek*, p.37, (February 3, 1997); Sheppard, "Rethinking Assumption of Liabilities in Spin-

interest of the old shareholders in the acquiror is converted from common to a different class of stock, in some instances, preferred, in other instances, stock with voting rights disproportionate to the value of such stock.[49]

It is argued that the basic function of section 355 should be to permit existing shareholders either to separate existing businesses pro-rata into more than one corporate structure, or to separate their ownership of different businesses, with some shareholders continuing ownership of one business and other shareholders continuing ownership of the other business.

In those cases in which it is intended that the ownership of a business will change in connection with a spin-off, it is argued that the tax-free provisions of section 355 should not apply at the corporate level, but rather the distributing corporation should be viewed as having disposed of a corporation and thus should not be exempt from tax at the corporate level.

Also, it is argued that it is very common for the corporation that remains owned by old shareholders to be relieved of a significant amount of debt in these transactions, thus suggesting the paradigm of a sale of a subsidiary at least in part for a cash equivalent. The Administration proposal would affect many such transactions, as well as other transactions, because debt shifting is not a factor in gain recognition under the proposal. However, creating specific rules directed at these debt situations could, however, be administratively difficult.

On the other hand, it is argued that so long as the consideration received is only stock, all assets remain in corporate hands without a step-up of basis, and no corporate stock obtains a step-up of basis, existing transactions should be permitted to continue on a tax-free basis. Arguably, it is desirable to permit the tax-free tailoring of businesses to those desired by a corporate acquiror, who should not be required to acquire all businesses of a corporate parent, and then dispose of some businesses later, in order to qualify for tax free treatment.

Other criticisms of the proposal are that it taxes the appreciation of the distributed corporation, even though the distributee may be the corporation that is changing hands; and that it imposes a corporate level tax based on a change of shareholder ownership of a portion of the

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Offs," *Tax Notes*, 709, (February 10, 1997).

[49] See, e.g., Sheppard, "The Inexplicable Viacom Ruling; or Did Aliens Kidnap IRS Lawyers," *Tax Notes*, 13 (July 1, 1996); Peaslee, "The Viacom Ruling--Two Ships Passing in the Night," *Tax Notes*, 1435 (September 9, 1996); "GM or Hughes Could Get Billions in Cash From Sale" *Wall Street Journal*, p. B4(January 8, 1997). The IRS has indicated that it will no longer rule on certain transactions that might not satisfy the requirement of distribution of control of a subsidiary if the steps of the transaction were rearranged. This could reduce the ability of some but not all such transactions to obtain an advance IRS ruling. Rev. Proc. 96-39, 1996-33 I.R.B. 11.

corporate businesses, while a change in ownership of all the businesses (e.g., in an acquisition of the entire parent corporation) would not trigger any corporate level tax.

In addition, it is argued that if there are problems perceived with the nature of the consideration received in some instances at the corporate or shareholder level, those issues could be addressed separately.

Finally, regarding the effective date, it is argued that these transactions are extremely common; numerous such transactions are being undertaken at any given time; the provisions permitting them have long been recognized; and that the proposed effective date should therefore be modified to allow transition for transactions with binding contracts or possibly with other stages of development at the time of any committee action.

7. 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 transactions after the date of first committee action.

Analysis

Section 304 is directed primarily at preventing a controlling shareholder from claiming basis recovery and capital gain treatment on transactions that result in a withdrawal of earnings from corporate solution. These concerns are most relevant where the shareholder is an individual. Different concerns may be present if the shareholder is a corporation, due in part to the presence of the dividends-received deduction. A corporation will often prefer a transaction to be characterized as a dividend, as opposed to a sale or exchange. Accordingly, a corporation may intentionally seek to apply section 304 to a transaction in order to obtain beneficial basis results that would not occur in substance a sale or exchange. Corporations that are related for purposes of section 304 need not be 80 percent controlled by a common parent. The separate rules for corporations filing a consolidated return, that would generally reduce basis for untaxed dividends received, do not apply. Furthermore, in some situations where the selling corporation does not in fact own any stock of the acquiring corporation before or after the transaction (except by attribution), it is possible that current law may lead to inappropriate results.

As one example, in certain related party sales, the selling corporation may take the position that its basis in any shares of stock it may have retained (or possibly in any shares of the acquiring corporation it may own) need not be reduced by the amount of the dividends received deduction. This can result in an inappropriate shifting of basis. The result can be artificial reduction of gain or creation of loss on disposition of any such retained shares.

As one example, assume that domestic corporation X owns 70 percent of the shares of domestic corporation S and all the shares of domestic corporation B. S owns all the shares of

domestic corporation T with a basis of $100. Assume that corporation B has sufficient earnings and profits so that any distribution of property would be treated as a dividend. Assume that S sells all but one of its shares in T to B for $99, their fair market value. Under present law, the transfer is treated as a redemption of shares of B, which redemption is treated as a dividend to S because, even though S in fact owns no shares of B, it is deemed to own all the shares of B before and after the transaction, through attribution from X. Taxpayers may contend that the one share of T retained by S (worth $1) retains the entire original basis of $100. Although S has received $99 from B for its other shares of T, and has not paid full tax on that receipt due to the dividends received deduction, S may now attempt to claim a $99 loss on disposition of the remaining share of T.

The proposal would change the above results by specifying that, in the transaction, B is deemed to issue new shares of B to S, and then to redeem those same shares for cash, with a required reduction in basis under section 1059 for the non-taxed portion of the payment that is deemed to be a dividend.

In international cases, a U.S. corporation owned by a foreign corporation may inappropriately claim foreign tax credits from a section 304 transaction. For example, if a foreign-controlled domestic corporation sells the stock of a subsidiary to a foreign sister corporation, the domestic corporation may take the position that it is entitled to credit foreign taxes that were paid by the foreign sister corporation. See, Rev. Rul. 92-86, 1992-2 C.B. 199; Rev. Rul. 91-5, 1991-1 C.B. 114. However, if the foreign sister corporation had actually distributed its earnings and profits to the common foreign parent, no foreign tax credits would have been available to the domestic corporation. The proposal would limit foreign tax credits to situations where an actual distribution would have entitled the group to a credit.

8. Modify the extension of section 29 credit for biomass and coal facilities

Present Law

Certain fuels produced from "nonconventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29). In 1995, the credit was $5.83 per barrel of oil equivalent.

Qualified fuels include: (1) oil produced from shale and tar sands; (2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite). Qualified fuels must be produced within the United States.

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal. The expiration dates for such facilities were extended in the Small Business Job Protection Act of 1996. Before that Act, only fuel produced from facilities placed

in service before January 1, 1997, pursuant to a binding contract entered into before January 1, 1996, would have been eligible for the credit. The Small Business Job Protection Act of 1996 extended the placed-in-service date by 18 months, and the binding contract date by one year, such that fuel produced from facilities placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997, are now eligible for the credit.

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

Description of Proposal

The proposal would shorten by one year the "placed in service" period for facilities producing gas from biomass and synthetic fuel from coal, such that only facilities placed in service before July 1, 1997, pursuant to a binding contract entered into before January 1, 1997, would be eligible for the credit.

Effective Date

The proposal would be effective on the date of enactment.

Analysis

The Administration proposal would repeal 12 months of the recent 18-month extension. The Administration has stated that the reason for this proposal is that the section 29 credit has been growing extremely rapidly, the extensions benefit only a handful of taxpayers, and additional extensions of the original 1992 transition rule are unwarranted. Because the binding contract date has already passed, however, the proposal might place an unfair financial burden on those taxpayers who are bound to contracts entered into prior to the Administration's announcement, for facilities to be placed in service after July 1, 1997, and before July 1, 1998.

C. Foreign Provisions

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

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 derived from transfers of debt securities (but not equity securities) pursuant to the rules governing securities lending transactions (sec. 1058) also 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 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.

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.

Analysis

The proposal would expand the definition of foreign personal holding company income to include net income from all notional principal contracts and payments in lieu of dividends pursuant to stock lending transactions covered by section 1058. This expansion would encompass some income items that are excluded from foreign personal holding company income under present law but that are economically equivalent to items that are included in such income under present law. Thus, the proposal would provide parity between similar types of income.

Under the proposal, amounts derived from notional principal contracts generally would constitute a separate category of foreign personal holding company income, instead of such amounts being included in a category based on the item to which the contract is referenced (e.g., commodities or foreign currency). However, if the notional principal contract is entered into as a hedge against an item in another category of foreign personal holding company income, then amounts derived from the contract would be included in such other category. Accordingly, amounts derived from a position and any offsetting amounts derived from a notional principal contract held to hedge that position would be netted within the same category of foreign personal holding company income. This treatment seems appropriate because it would associate a notional principal contract entered into as a hedge with the position that the contract hedges.

The proposal also would provide an overall exception from foreign personal holding company income for certain amounts derived by a dealer in the ordinary course of its trade or business as a dealer. This exception, unlike those under present law, would apply to dealers in financial instruments referenced to commodities. This exception appears appropriate because income derived by a dealer represents income from a business even though similar income in the hands of a nondealer would constitute passive income.

2. Taxation of certain captive insurance companies and their shareholders

Present Law

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

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

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

Under the subpart F rules, certain U.S. shareholders of a controlled foreign corporation (CFC) are required to include in income currently their shares of certain income of the CFC, whether or not such income is actually distributed to the shareholders. This current inclusion rule applies to certain insurance income of the CFC. In addition, special provisions under the subpart F rules apply to require current inclusion of the related person insurance income of a CFC. A look-through rule applies in characterizing the current inclusion with respect to certain subpart F insurance income for purposes of determining the unrelated business taxable income of a tax-exempt organization.

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

Description of Proposal

In general

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

Disqualified shareholder insurance would be an insurance or reinsurance policy issued directly or indirectly with respect to a person who is a "large shareholder" of the issuing

corporation, or a person related to such a shareholder. An insurance or reinsurance policy would not constitute disqualified shareholder insurance if the ultimate insured is not a large shareholder or a related person (e.g., a third-party risk that is reinsured by the issuing company's affiliate).

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

Treatment of disqualified corporation

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

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

Treatment of large shareholder and related persons

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

Application to reinsurance

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

insurance. If any portion of an insurance contract is ceded to a person who is related to the ultimate insured, that portion may be treated as disqualified shareholder insurance (if the ultimate insured is related to the assuming insurance company) . The proposal would not apply to reinsurance transactions between affiliated insurance companies, if the insured risks were not related party risks with respect to the ceding or the assuming insurance companies.

Foreign personal holding company income

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

Application of excise tax

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

Information reporting

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

Regulatory authority

The Secretary of the Treasury would have authority to prescribe regulations as necessary or appropriate to carry out the purposes of the proposal. The Secretary could issue regulations: (1) preventing avoidance of these rules through cross-insurance or multiple-contract arrangements or otherwise; (2) preventing items from being taken into account more than once; (3) providing that the determination of whether a corporation with disqualified shareholder insurance qualifies as an insurance company is made on the basis of the average of its net written premiums over multiple years; and (4) treating persons as related by reason of contractual arrangements or otherwise.

Effective Date

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

Analysis

The proposal responds to the tax policy concern that a deduction should not be permitted for what amounts to self-funding of liabilities. The proposal would resolve legislatively issues that have been addressed principally in the courts, and would consequently add clarity to the law, it is argued. The proposal is also designed to require additional information reporting to assist the Internal Revenue Service in enforcing existing tax rules that address related policy concerns.

On the other hand, some counter that captive insurers serve a useful function in providing an alternative to commercial insurance, and should not be discouraged by subjecting them to unfavorable tax rules, despite the tax policy concern about deducting self-funded liabilities. Further, it could be said that, in its current form, the proposal does not add much clarity to present law, because whether the insurer is subject to the provision would still depend on the application of the "primary and predominant" test of present law. Persons with this view might argue for modifying the proposal to provide a bright-line test, such as a test based exclusively on the percentage of net written premiums attributable to large shareholders. The proposal could also be criticized on the ground that a 10-percent ownership test is an arbitrary determination of when a payment should be considered as made to oneself. Another criticism is that the proposal does not address the issue of whether experience-rated (including retrospectively rated) policies, or other similar arrangements, should be treated as insurance.

3. Modify foreign tax credit carryover rules

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 foreign tax credit limitations are applied to specific categories of income.

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and forward five years. The amount carried over may be used as a credit in a carryover year to the extent the taxpayer otherwise has excess foreign tax credit limitation for such year. The separate foreign tax credit limitations apply for purposes of the carryover rules.

Description of Proposal

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

Effective Date

The proposal would apply to foreign tax credits arising in taxable years beginning after December 31, 1997.

Analysis

It is argued that the carryback of foreign tax credits gives rise to more complexity and greater administrative burdens than does the carryforward of foreign tax credits. Accordingly, shortening the carryback period and lengthening the carryforward period could reduce complexity. It could be argued further that reducing the carryback period might be appropriate in light of the ability of taxpayers that operate through foreign subsidiaries to control the timing of the recognition for U.S. tax purposes of income with respect to such subsidiaries and credits for the foreign taxes paid by such subsidiaries.

One of the purposes of the carryover of foreign tax credits is to address timing differences between U.S. tax rules and foreign tax rules. An item of income may be subject to U.S. tax in one year but subject to foreign tax in a different year; the carryover of foreign tax credits helps to ensure that foreign taxes will be allowed as a credit against U.S. taxes even when such taxes are not paid or accrued in the same year. Shortening the foreign tax credit carryback period to one year could have the effect of denying taxpayers a foreign tax credit in cases where the U.S. tax on an item of income is paid more than one year earlier than the foreign tax on the same of item of income. On the other hand, lengthening the foreign tax credit carryforward period to seven years could have the effect of expanding taxpayers' abilities to average high-taxed foreign income and low-taxed foreign income for purposes of the foreign tax credit. Shortening the carryback period and increasing the carryforward period also could have the effect of reducing the present value of foreign tax credits and therefore increasing the effective tax rate on foreign source income.

4. Reform treatment of foreign oil and gas income and dual-capacity taxpayers

Present Law

U.S. persons are subject to U.S. income tax on their worldwide income. A credit against U.S. tax on foreign source income is allowed for foreign taxes. The foreign tax credit is available only for foreign income, war profits, and excess profits taxes and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses only. Treasury regulations provide detailed rules for determining whether a foreign levy is a creditable income tax. A levy generally is a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit

provided by a foreign country. A taxpayer that is subject to a foreign levy and also receives a specific economic benefit from such country is considered a "dual capacity taxpayer." Under a safe harbor provided in the regulations, the portion of a foreign levy paid by a dual capacity taxpayer that is creditable is determined based on the foreign country's generally applicable tax or, if the foreign country has no general tax, the U.S. tax (Treas. Reg. sec. 1.901-2A(e)).

The amount of foreign tax credits that a taxpayer may claim in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. The foreign tax credit limitation is calculated separately for specific categories of income. The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years. Under a special limitation, taxes on foreign oil and gas extraction income are creditable only to the extent that they do not exceed a specified amount (e.g., 35 percent of such income in the case of a corporation). A taxpayer must have excess limitation under the special rules applicable to foreign extraction taxes and excess limitation under the general foreign tax credit provisions in order to utilize excess foreign oil and gas extraction taxes in a carryback or carryforward year. A recapture rule applicable to foreign oil and gas extraction losses treats income that otherwise would be foreign oil and gas extraction income as foreign source income that is not considered oil and gas extraction income; the taxes on such income retain their character as foreign oil and gas extraction taxes and continue to be subject to the special limitation imposed on such taxes.

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on their shares of certain income earned by the corporation, whether or not such income is distributed to the shareholders. Such income includes, among other things, foreign base company oil related income (sec. 954(g)). Foreign base company oil related income is income derived outside the United States from the processing of minerals extracted from oil or gas wells into their primary products; the transportation, distribution, or sale of such minerals or primary products; the disposition of assets used by the taxpayer in a trade or business involving the foregoing; or the performance of any related services. However, foreign oil related income does not include income derived from a source within a foreign country in connection with (1) oil or gas which was extracted from a well located in such foreign country or (2) oil, gas, or a primary product of oil or gas which is sold by the CFC or a related person for use or consumption within such foreign country or is loaded in such country as fuel on a vessel or aircraft. An exclusion also is provided for income of a CFC that is a small producer (i.e., a corporation whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

Description of Proposal

The proposal would deny the foreign tax credit with respect to all amounts paid or accrued (or deemed paid) to any foreign country by a dual-capacity taxpayer if the country does not impose a generally applicable income tax. A dual-capacity taxpayer would be a person who is subject to a foreign levy and also receives (or will receive) directly or indirectly a specific

economic benefit from such foreign country. A generally applicable income tax would be an income tax that is imposed on income derived from business activities conducted within that country, provided that the tax has substantial application (by its terms and in practice) to persons who are not dual capacity taxpayers and to persons who are citizens or residents of the foreign country. If the foreign country imposes a generally applicable income tax, the foreign tax credit available to a dual-capacity taxpayer would not exceed the amount of tax that is paid pursuant to the generally applicable income tax or that would be paid if the generally applicable income tax were applicable to the dual-capacity taxpayer. Amounts for which the foreign tax credit is denied could constitute deductible expenses. The proposal would not apply to the extent contrary to any treaty obligation of the United States.

The proposal would replace the special limitation rules applicable to foreign oil and gas extraction income with a separate foreign tax credit limitation under section 904(d) with respect to foreign oil and gas income. For this purpose, foreign oil and gas income would include foreign oil and gas extraction income and foreign oil related income. The proposal would repeal both the special carryover rules applicable to excess foreign oil and gas extraction taxes and the recapture rule for foreign oil and gas extraction losses.

The proposal would treat foreign oil and gas income as income which is subject to current U.S. taxation under the rules of subpart F. As in the case of the foreign tax credit limitation, foreign oil and gas income would include both foreign oil related income and foreign oil and gas extraction income. The present-law exclusion for income derived from a source within a foreign country in connection with oil or gas extracted from a well in such country or oil, gas or a primary product sold for use or consumption within such country or loaded in such country as fuel on a vessel or aircraft would be eliminated. The small producer exception to the subpart F rules would be retained and would apply to both foreign oil and gas extraction income and foreign oil related income.

Effective Date

The proposal with respect to the treatment of dual-capacity taxpayers would apply to taxes paid or accrued in taxable years beginning after the date of enactment. The proposal with respect to the foreign tax credit limitation generally would apply to taxable years beginning after the date of enactment. The proposal with respect to the subpart F provisions would be effective for taxable years of CFCs beginning after the date of enactment.

Analysis

The proposal with respect to the treatment of dual-capacity taxpayers would address the distinction between creditable taxes and non-creditable payments for a specific economic benefit. The proposal would modify the safe harbor rule currently provided by Treasury regulations and would deny a foreign tax credit for amounts paid by a dual-capacity taxpayer to a foreign country that does not have a generally applicable income tax. Issues necessarily would

continue to arise in determining whether a taxpayer is a dual-capacity taxpayer and whether a foreign tax is a generally applicable income tax.

Under the proposal, a separate foreign tax credit limitation (or "basket") would apply to foreign oil and gas income, which would include both foreign oil and gas extraction income and foreign oil related income. In addition, the present-law special limitation for extraction taxes would be eliminated. The proposed single basket rule may provide some simplicity by eliminating issues that arise under present law in distinguishing between income that qualifies as extraction income and income that qualifies as oil related income. The proposal also would have the effect of allowing the foreign taxes on extraction income, which may be imposed at relatively high rates, to be used to offset the U.S. tax on foreign oil related income, which may be subject to lower-rate foreign taxes.

The proposal would extend the subpart F rules to foreign oil and gas extraction income, subjecting the U.S. 10-percent shareholders of a CFC to current U.S. tax on such income. In addition, the proposal would expand the reach of the subpart F rules with respect to foreign oil related income by eliminating the present-law exclusion for certain oil related income derived in the same country in which the oil or gas is extracted or is to be used; accordingly, the U.S. 10-percent shareholders of a CFC would be subject to current U.S. tax on such income. As with the proposed single foreign tax credit basket, it is argued that the inclusion of extraction income under the subpart F rules would result in simplification by eliminating the need to distinguish between extraction income and oil related income. However, others argue that the proposed expansion of the subpart F rules is inconsistent with the tax policy underlying such provisions. The subpart F rules historically have been aimed at requiring current inclusion of income of a CFC that is either passive or easily movable. The categories of foreign oil and gas income that would be added to subpart F income under the proposal (i.e., foreign oil and gas extraction income and certain same-country foreign oil related income) do not constitute income that is either passive or manipulable as to location.

5. Replace sales source rules with activity-based rule

Present Law

U.S. persons are subject to U.S. tax on their worldwide income. Foreign taxes may be credited against U.S. tax on foreign source income of the taxpayer. For purposes of computing the foreign tax credit, the taxpayer's income from U.S. sources and from foreign sources must be determined.

Income from the sale or exchange of inventory property that is produced (in whole or in part) within the United States and sold or exchanged outside the United States, or produced (in whole or in part) outside the United States and sold or exchanged within the United States, is treated as partly from U.S. sources and partly from foreign sources. Treasury regulations provide that 50 percent of such income is treated as attributable to production activities and 50 percent is treated as attributable to sales activities. Alternatively, the taxpayer may elect to

determine the portion of such income that is attributable to production activities based upon an available independent factory price (i.e., the price at which the taxpayer makes a sale to a wholly independent distributor in a transaction that reasonably reflects the income earned from the production activity). With advance permission of the Internal Revenue Service, the taxpayer instead may elect to determine the portion of its income attributable to production activities and the portion attributable to sales activities based upon its books and records.

The portion of the income that is considered attributable to production activities generally is sourced based on the location of the production assets. The portion of the income that is considered attributable to sales activities generally is sourced where the sale occurs. Treasury regulations provide that the place of sale will be presumed to be the United States if the property is wholly produced in the United States and is sold for use, consumption, or disposition in the United States.

Description of Proposal

Under the proposal, income from the sale or exchange of inventory property that is produced in the United States and sold or exchanged abroad, or produced abroad and sold or exchanged in the United States, would be apportioned between production activities and sales activities based on actual economic activity.

Effective Date

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

Analysis

The 50/50 source rule of present law may be viewed as drawing an arbitrary line in determining the portion of income that is treated as attributable to production activities and the portion that is treated as attributable to sales activities. The proposal could be viewed as making this determination more closely reflective of the economic components of the export sale. Some further argue that the present-law rule provides a tax benefit only to U.S exporters that also have operations in high-tax foreign countries. In many cases, the income from a taxpayer's export sales is not subject to tax in the foreign jurisdiction and therefore does not give rise to foreign tax credits. The present-law treatment of 50 percent of the income from a taxpayer's export sales of property it manufactured in the United States as foreign source income therefore has the effect of allowing the taxpayer to use excess foreign tax credits, if any, that arise with respect to other operations. It is argued that the proposal would prevent what might be viewed as the inappropriate use of such excess foreign tax credits.

Others argue that the export benefit provided by the 50/50 source rule of present law is important to the U.S. economy and should be retained. It is further argued that the rule is needed to counter-balance various present-law restrictions on the foreign tax credit that can operate to deny the taxpayer a credit for foreign taxes paid with respect to foreign operations, thereby

causing the taxpayer to be subject to double tax on such income. Moreover, the 50/50 source rule of present law can be viewed as having the advantage of administrative simplicity; the proposal to apportion income between the taxpayer's production activities and its sales activities based on actual economic activity has the potential to raise complex factual issues similar to those raised under the section 482 transfer pricing rules that apply in the case of transactions between related parties.

II. OTHER TAX PROVISIONS

A. Accounting Provisions

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

Present Law

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

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

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income over time (sec 447(i)). The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change.

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

Description of Proposal

The proposal would repeal the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the proposal, any family farm corporation required to change to an accrual method of accounting

would restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change. In addition, any taxpayer with an existing suspense account would be required to restore the account into income ratably over a 10-year period, beginning with the first taxable year beginning after the effective date.

Effective Date

The proposal would be effective for taxable years ending after the date of first committee action.

Analysis

The proposal is substantially similar to a provision that was contained in the Balanced Budget Act of 1995 (H.R. 2491, 104th Cong., "BBA") as passed by the Congress and vetoed by President Clinton. However, the BBA version would have allowed taxpayers with existing suspense accounts to restore the accounts into income over a 20-year period (rather than a 10-year period).

Several issues must be considered in developing the appropriate base of the Federal income tax. On the one hand, so as not to create distortions among competing business investment decisions and activities, it is argued that the income tax should be applied to economic income. On the other hand, in order to promote compliance and reduce administrative burdens, a tax system should be understandable and administrable. It is generally conceded that economic income is sometimes difficult to measure.

In general, under an accrual method of accounting, income is recognized and deductions are allowed as the related items of income and expense arise and become measurable. Under the cash receipts and disbursements method ("cash method"), in general, income is recognized and deductions are allowed as the cash income is received and expenses are paid. An accrual method more accurately measures economic income, while the cash method is easier to comply with. Thus, most corporations and all businesses where inventory is a material income-producing factor are required to use an accrual method, while most individuals and many small corporations are allowed to use the cash method. Once a corporation reaches a certain size, it is generally required to switch from the cash method to an accrual method.

Changes in methods of accounting affect the timing of when items of income or expenses are taken into account. Whenever a taxpayer changes its method of accounting, the change generally is implemented under Code section 481 in a manner so that items of income or expense are not taken into account twice--once under the old method and again under the new method--or omitted completely under both methods. Section 481 requires the calculation of an adjustment that reflects the cumulative effect of the method change and the amount of the adjustment is restored to income over a specified period of time.

The present-law suspense account provision applicable to large family farm corporations represents an exception to the general rules applicable to a taxpayer that is required to change its method of accounting. Furthermore, present-law suspense accounts effectively may provide an exclusion for, rather than a deferral of, amounts otherwise properly taken into account under section 481 upon the required change in method.

Opponents of the proposal argue that Congress, in the 1987 Act, has already addressed the manner by which family farm corporations should implement a change to the accrual method of accounting and to now require the restoration of existing suspense accounts would impose liquidity constraints on taxpayers that relied upon present law and would be retroactive in nature.

2. Repeal lower of cost or market inventory accounting method

Present Law

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

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

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

Retail merchants may use the "retail method" in valuing ending inventory. Under the retail method, the total of the retail selling prices of goods on hand at year end is reduced to approximate cost by deducting an amount that represents the gross profit embedded in the retail prices. The amount of the reduction generally is determined by multiplying the retail price of goods available at yearend by a fraction, the numerator of which is the cost of goods available for sale during the year and the denominator of which is the total retail selling prices of the goods available for sale during the year, with adjustments for mark-ups and mark-downs (Treas. reg. sec. 1.471-8(a)). Under certain conditions, a taxpayer using the FIFO method may determine

the approximate cost or market of inventory by not taking into account retail price mark-downs for the goods available for sale during the year, even though such mark-downs are reflected in the retail selling prices of the goods of goods on hand at year end (Treas. reg. sec. 1.471-8(d)). As a result, such taxpayer may write down the value of inventory below both its cost and its market value.

Description of Proposal

The proposal would repeal the LCM method and the subnormal goods method. Appropriate wash-sale rules would be provided. The proposal would not apply to taxpayers with average annual gross receipts over a three-year period of $5 million or less.

Effective Date

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

Analysis

Under present law, income or loss generally is not recognized until it is realized. In the case of a taxpayer that sells goods, income or loss generally is realized and recognized when the goods are sold or exchanged. The LCM and subnormal goods inventory methods of present law represent exceptions to the realization principle by allowing the recognition of losses without a sale or exchange. In addition, these methods are one-sided in that they allow the recognition of losses, but not gains, even if the items of inventory recover their value in a subsequent year.

In general, the LCM and subnormal goods inventory methods have been long-accepted as generally accepted accounting principles ("GAAP") applicable to the preparation of financial statements and have been allowed by Treasury regulations for tax purposes since 1918. However, the mechanics of the tax rules differs from the mechanics of the financial accounting rules. Moreover, the conservatism principle of GAAP requires the application of the LCM and subnormal goods methods so that the balance sheets of dealers in goods are not overstated relative to realizable values. There is no analog to the conservatism principle under the Federal income tax.

3. Repeal components of cost inventory accounting method

Present Law

During periods of rising prices, the LIFO method of accounting for inventory reduces taxable income relative to the FIFO method because the LIFO method assumes that the inventory items sold during the year were those most recently acquired by the taxpayer.

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

The proper application of the COC method to labor and overhead is unclear under present law.[50] Accordingly, the COC method as applied by some taxpayers may produce different results than the TPC method whenever a taxpayer's production processes change between the base year and the current year. For example, assume that in the base year the taxpayer can produce an item by applying 5 units of material at $8 a unit, 10 hours of direct labor at $10 an hour, and 10 hours of overhead at $5 an hour.[51] Thus, it costs $190 to produce an item in the base year (5 times $8, plus 10 times $10, plus 10 times $5). Further assume that: (1) the taxpayer's production processes change such that in the current year it now takes 5 units of materials, 5 hours of direct labor, and 5 hours of overhead to produce the same item; (2) the prices for materials, labor, and overhead have remained constant from the base year to the current year; and (3) one item of

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

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

inventory remains at the end of the current year. Under the TPC method, because prices have remained constant, ending inventory would be valued at $190 (the total product cost of producing one item in the base year). Under the COC method as applied by some taxpayers, ending inventory could be valued at $115 (5 units of materials times $8, plus 5 hours of direct labor times $10, plus 5 hours of overhead times $5).

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

Inventory is determined under TPC and COC methods described above using indexes that the taxpayer develops from its own internal cost experience. Alternatively, taxpayers using dollar-value LIFO may apply external indexes prepared and published by the Bureau of Labor Statistics. Small businesses may use external government indexes under the simplified LIFO method of Code section 474. Retail department stores may use the external indexes set out in various IRS revenue procedures. Other businesses may use the method described in Treasury regulation section 1.472-8(e)(3); these taxpayers generally are limited to using 80 percent of the change in the appropriate external price index.

Description of Proposal

The proposal would repeal the COC method.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment. For taxpayers continuing to use a LIFO method of valuing inventory, the proposal would be applied on a cut-off basis. For taxpayers switching to a FIFO or other method of valuing inventory, the proposal would be applied pursuant to the present-law rules governing such changes in methods of accounting.

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

Analysis

The application of the COC method under present law combines elements of the LIFO method (with respect to prices) and the FIFO method (with respect to the taxpayer's production processes). This application may result in the mismeasurement of income to the extent the taxpayer becomes more efficient in the production of goods or substitutes one component of production for another. Thus, it is unclear whether or to what extent the COC method takes into account more than inflation. Some would argue that LIFO is intended to reduce or eliminate the effects of inflation upon inventory, and nothing more.

The COC method is an inventory method that is accepted (and in some cases, favored) under generally accepted accounting principles ("GAAP") applicable to the preparation of financial statements and is allowed under Treasury regulations with respect to raw materials and the raw material content of work-in-process and finished goods. In theory, the COC method seems most appropriate in cases where the types of goods the taxpayer produces changes from year to year. If the COC method is repealed, taxpayers wishing to retain LIFO would be required to use the TPC method or an external index method of present law. Switching from the COC method to the TPC method or an external index method for tax purposes will not automatically lead to a change for financial accounting purposes, requiring some taxpayers to maintain two sets of inventory records.

It is unclear whether it is possible or practical for some taxpayers to change to the TPC method. In order to apply the TPC method, a taxpayer must ascertain the total product cost for an item for the base tear (generally, the first year for which LIFO was adopted). If the taxpayer did not produce such item in such year, Treasury regulations provide that the taxpayer may reconstruct its base year costs (i.e., determine what the item would have cost had the taxpayer produced it). Such reconstructions may be difficult, time consuming, and may lead to additional disputes between the IRS and taxpayers as to the accurate measure of income.

Taxpayers unable or unwilling to use the TPC method may use one of the LIFO methods of present law that generally determine the inflation component of inventory by reference to published price indexes. However, such methods may be unattractive to many taxpayers because (1) the published price indexes are compilations that may not accurately reflect the actual inflation experience of the taxpayer, (2) many taxpayers are limited to using 80 percent of the change in the appropriate price indexes, and (3) the application of such methods under regulations may be cumbersome. It should be noted that when the Administration first proposed the repeal of the COC method (in 1994, as a GATT funding measure), the Administration also proposed a simplified LIFO method that could be used by any taxpayer, including those converting from the COC method. That simplified method would have allowed the use of 100 percent of the change in the appropriate price index and would have streamlined the mechanics of present Treasury regulations. A simplified LIFO proposal has not been included in the current budget proposal.

B. Gain Deferral Provisions

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

Present Law

Gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified replacement period of time (sec. 1033). Subchapter C corporations (and certain partnerships with corporate partners) are not entitled to defer gain under section 1033 if the replacement property or stock is purchased from a related person.

Description of Proposal

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

Effective Date

The proposal would apply to involuntary conversions occurring after the first date of committee action.

Analysis

A taxpayer is allowed to defer gain with respect to property that is involuntarily converted to the extent the taxpayer acquires similar property within a specified time period. Prior to 1995, a corporation could satisfy this requirement by acquiring property from a related party. In such instances, the group of related corporations could both retain the proceeds received from the involuntarily converted property on tax-free basis without making any new investment in similar property. Pursuant to a provision of Public Law 104-7, enacted on April 11, 1995, corporations no longer can avail themselves of deferral under section 1033 by acquiring replacement property from a related corporation. The proposal would extend this rule to taxpayers other than corporations.

One issue raised by the legislation is whether it is appropriate to apply the proposal in all related party cases. For instance, present law section 1041(b) makes it clear that a transfer of property between spouses is not treated as a sale or exchange because the husband and wife should be viewed as an economic unit in the same way a parent corporation and its subsidiary

may be viewed as an economic unit. However, it is less clear whether a similar prohibition should apply to transactions between other family members (e.g., between siblings.)

2. Further restrict like-kind exchanges involving foreign personal property

Present Law

Like-kind exchanges

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 a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a 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 both outside the United States. In addition, certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

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

Application of depreciation rules

Tangible personal property that is used predominantly outside the United States generally is accorded a less favorable depreciation regime than is property that is used predominantly within the United States. Thus, under present law, if a taxpayer exchanges depreciable U.S. property with a low adjusted basis (relative to its fair market value) for similar property situated outside the United States, the adjusted basis of the acquired property will be the same as the adjusted basis of the relinquished property, but the depreciation rules applied to such acquired property generally will be different than the rules that were applied to the relinquished property.

Description of Proposal

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

Effective Date

The proposal would be effective for transfers after the date of first committee action.

Analysis

The proposal would restrict the ability of taxpayers to shift adjusted basis among types of property subject to different depreciation regimes. For example, assume that a taxpayer has $1 million cash and a fleet of used rental cars in the United States that are fully depreciated but have a fair market value of $1 million. Further assume that the taxpayer wishes to acquire two new rental fleets of cars, each with a value of $1 million. One fleet will be used within the United States and the other will be used outside the United States. Under present law, the taxpayer would be advised to exchange its old U.S. fleet for the new foreign fleet and purchase the new U.S. fleet for cash. In this way, the taxpayer would have a full fair market value basis in the U.S. fleet (which is subject to a more favorable depreciation schedule) and a zero carryover basis in the foreign fleet. In addition, if both fleets were sold soon after the acquisition, a disproportionate amount of the gain would be foreign-source income.

In some instances the proposal is under-inclusive because it does not address all cases where adjusted basis may be shifted. For example, less favorable depreciation regimes are accorded not only to foreign use property, but tax-exempt use property and tax exempt bond-financed property as well. Basis, depreciation method, or income-source shifting also may occur when property of one class life is exchanged for property of another class life, or when a property is simply put into another use or location.

On the other hand, the proposal may be over-inclusive in that it may reach cases where the taxpayer is not shifting basis. For example, if the adjusted basis of property approximates its fair market value, the exchange of U.S. property for foreign property produces a detrimental tax result under present law.

C. Administrative Provisions

1. Registration of confidential corporate tax shelters

Present Law

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

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

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

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

Description of Proposal

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

discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

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

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

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

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

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

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

Effective Date

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

Analysis

The proposal may improve compliance with the tax laws by giving the Treasury Department earlier notification than it generally receives under present law of transactions that may not comport with the tax laws. In addition, the proposal may improve compliance by discouraging taxpayers from entering into questionable transactions. Also, investments that are not economically motivated, but that are instead tax-motivated, may reduce the supply of capital available for economically motivated activities, which could cause a loss of economic efficiency. On the other hand, the proposal could also discourage taxpayers from entering into legitimate transactions, which could cause a loss of economic efficiency. In addition, the proposal will divert resources from potentially legitimate economic activities into complying with the provision. Also, because in some instances it may be necessary to exercise judgment as to whether a transaction must be reported, there may develop disagreements between the private sector and the government as to the proper extent of reporting required by the statute.

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.

Analysis

Lowering the information reporting threshold from $25,000 to $600 may improve compliance because additional, small-dollar value contracts will be reported. It may be unclear to some why the Treasury Department has not already exercised its authority to provide for a lower threshold, in light of the compliance benefits.

3. Increased information reporting penalties

Present Law

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

There is a special rule for de minimis failures to include the required, correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

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

the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

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

Description of Proposal

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

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

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

Effective Date

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

Analysis

Some of the information returns subject to this proposed increased penalty report amounts that are income, such as interest and dividends. Other information returns subject to

this proposed increased penalty report amounts that are gross proceeds.[52] Imposing the penalty as a percentage of the amount required to be reported might be viewed as disproportionately affecting businesses that file information returns reporting gross proceeds.

4. 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(l)(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.[53]

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[52] Gross proceeds reports are useful to indicate that a potentially income-producing event has occurred, even though the amount reported on the information return bears no necessary relationship to the amount of income ultimately reported on the income tax return.

[53] See page 902 of the Appendix to the Budget. Extension through September 30, 2002, which is described on page 84 of the Treasury Department's General Explanations of the Administration's Revenue Proposals (February 1997), is not the Administration's current policy.

Effective Date

The proposal would be effective on the date of enactment.

Analysis

Some may consider it appropriate to permit disclosure of otherwise confidential tax information to ensure the correctness of government benefits payments. Others may be concerned that the many exceptions permitting disclosure, while perhaps justified on an individual basis, may collectively erode voluntary compliance with the tax laws.

5. Extension of withholding to certain gambling winnings

Present Law

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

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

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

Description of Proposal

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

Effective Date

The proposal would be effective for payments made after the beginning of the first month that begins at least 10 days after the date of enactment.

Analysis

It is generally believed that imposing withholding on winnings from bingo and keno will improve tax compliance and enforcement.

6. 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 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.

Analysis

The proposal could have a positive impact on compliance with the tax laws by requiring additional information reporting. On the other hand, imposing additional information reporting requirements will also impose costs on the private sector. Some might consider it inappropriate to single out payments to one profession for additional information reporting. Others would respond that reporting is appropriate in this instance because attorneys are generally the only professionals who receive this type of payment, a portion of which may be income to them and a portion of which may belong to their client.

7. Modify the substantial understatement penalty

Present Law

A 20-percent penalty applies to any portion of an underpayment of income tax required to be shown on a return that is attributable to a substantial understatement of income tax. For this purpose, an understatement is considered "substantial" if it exceeds the greater of (1) 10 percent of the tax required to be shown on the return, and (2) $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Generally, the amount of an "understatement" of income tax is the excess of the tax required to be shown on the return, over the tax shown on the return (reduced by any rebates of tax). The substantial understatement penalty does not apply if there was a reasonable cause for the understatement and the taxpayer acted in good faith with respect to the understatement (the "reasonable cause exception"). The determination as to whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.

Description of Proposal

The proposal would treat a corporation's deficiency of more than $10 million as substantial for purposes of the substantial understatement penalty, regardless of whether it exceeds 10 percent of the taxpayer's total tax liability.

Effective Date

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

Analysis

Opponents might argue that altering the present-law penalty to make it apply automatically to large corporations might be viewed as violating the policy basis for this penalty, which is to punish an understatement that is substantial or material in the context of the taxpayer's own tax return. Proponents might respond that a deficiency of more that $10 million is material in and of itself, regardless of the proportion it represents of that taxpayer's total tax return.

8. 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 demand[54] by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,[55] 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.[56]

In general, a levy does not apply to property acquired after the date of the levy,[57] 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.[58] The only exception to this rule is for salary and wages.[59] 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.

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[54] 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).

[55] Code sec. 6331.

[56] Code secs. 6335-6343.

[57] Code sec. 6331(b).

[58] Code sec. 6331(c).

[59] Code sec. 6331(e).

A minimum exemption is provided for salary and wages.[60] 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.[61] For a family of four for taxable year 1996, the weekly minimum exemption is $325.[62]

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.

Effective Date

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

Analysis

The extension of the continuous levy provisions will substantially ease the administrative burdens of collecting taxes by levy. Taxpayers who already comply with the tax laws may have a positive view of increased collections of taxes owed by taxpayers who have not complied with the tax laws.

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[60] Code sec. 6334(a)(9).

[61] Code sec. 6334(d).

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

b. Modifications of levy exemptions

Present Law

The Code exempts from levy workmen's compensation payments[63] and annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act[64] described above.

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:

(1) workmen's compensation payments,[65] and

(2) annuity or pension payments under the Railroad Retirement Act and benefits under the Railroad Unemployment Insurance Act.

Effective Date

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

Analysis

Some would argue that if wages are subject to levy, wage replacement payments should also be subject to levy. In addition, some would argue that it is inappropriate to exempt from levy one type of annuity or pension payment while most other types of these payments are subject to levy.

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[63] Code sec. 6334(a)(7).

[64] Code sec. 6334(a)(6).

[65] 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.

D. Employment and Excise Taxes

1. Extension of Federal unemployment surtax

Present Law

The Federal Unemployment Tax Act (FUTA) imposes a 6.2 percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2-percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Since all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the system, half of the Federal-State extended benefits program, and a Federal account for State loans. The States use the revenue turned back to them by the 5.4 percent credit to finance their regular State programs and half of the Federal-State extended benefits program.

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

Description of Proposal

The proposal would extend the temporary surtax rate through December 31, 2007.

Effective Date

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

Analysis

Some proponents of the surtax extension argue that it will increase the Federal trust fund balance to provide a cushion against future expenditures. They contend that the adequacy of the State trust funds is determined ultimately by the level of benefits provided under the State programs and the occurrence of future recessionary periods. If future recessionary periods result in the depletion of the State trust funds, the monies in the Federal trust fund will be used to make loans to the State trust funds. Opponents argue that the surtax was intended to be temporary and that extending it is unnecessary in light of the current trust fund balances. To support this position, they point to the fact that current Administration projections do not include any near-term recessionary periods. Opponents of the proposal also argue that retaining the surtax increases costs to employers, thereby impeding job creation.

2. Deposit requirement for Federal unemployment taxes

Present Law

If an employer's liability for Federal unemployment (FUTA) taxes is over $100 for any quarter, it must be deposited by the last day of the first month after the end of the quarter. Smaller amounts are subject to less frequent deposit rules.

Description of Proposal

The proposal would require an employer to pay Federal and State unemployment taxes on a monthly basis in a given year if the employer's FUTA tax liability in the prior year was $1,100 or more. The deposit with respect to wages paid during a month would be required to be made by the last day of the following month. A safe harbor would be provided for the required deposits for the first two months of each calendar quarter. For the first month in each quarter, the payment would be required to be the lesser of 30 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the month. The cumulative deposits paid in the first two months of each quarter would be required to be the lesser of 60 percent of the actual FUTA liability for the quarter or 90 percent of the actual FUTA liability for the two months. The employer would be required to pay the balance of the actual FUTA liability for each quarter by the last day of the month following the quarter. States would be required to establish a monthly deposit mechanism but would be permitted to adopt a similar safe harbor mechanism for paying State unemployment taxes.

Effective Date

The proposal would be effective for months beginning after December 31, 2001.

Analysis

Proponents argue that the new deposit requirements will: (1) provide a regular inflow of money to State funds to offset the regular payment of benefits and, (2) reduce losses to the Federal unemployment trust funds caused by employer delinquencies. Opponents respond that the State trust funds already have sufficient funds for the payment of benefits and find no evidence that more frequent deposits reduce employer delinquencies. Finally, opponents contend that the proposal's administrative burden significantly outweighs its benefits.

3. Kerosene taxed as diesel fuel

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 General Fund tax rate of 4.3 cents per gallon. In addition, through September 30, 1997, jet fuel used in noncommercial aviation is subject to an additional tax rate of 17.5 cents per gallon for the Airport and Airway Trust Fund (aggregate tax of 21.8 cents per gallon). Gasoline used in noncommercial aviation is subject to an additional Airport and Airway Trust Fund tax rate of 15 cents per gallon (aggregate tax of 19.3 cents per gallon). 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 cold temperatures. Under present law, kerosene is not subject to tax unless it is blended with taxable diesel fuel or is sold for use as aviation fuel. When kerosene is blended with dyed diesel fuel to be used in a nontaxable use, the dye concentration of the fuel mixture must be adjusted to ensure that it meets Treasury Department requirements for untaxed, dyed diesel fuel.

Clear, low-sulphur kerosene (K-1) also is used in space heaters, and often is sold for this purpose at retail service stations. As with other heating oil uses, kerosene used in space heaters, is not subject to Federal excise tax. 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 unseasonable cold 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. Subject to the exceptions described below, tax exemption would be realized through refunds for undyed kerosene that ultimately was used in a nontaxable use.

Aviation-grade kerosene that was 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 received 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. Finally, 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, and the Internal Revenue Service (the "IRS") 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.

Analysis

Before 1986, gasoline was taxed at the wholesale level and the excise tax on diesel fuel was imposed at the retail level. During the mid-1980s, the Congress received numerous reports of significant gasoline tax evasion involving creation of "shell" corporations by organized crime elements. In response, the Tax Reform Act of 1986 restructured the gasoline tax collection rules generally to the provisions of present law, imposing the tax upon removal from a terminal facility. After the gasoline tax rules were changed, gasoline excise tax receipts increased, but reports of evasion activities similar to those which previously occurred with gasoline surfaced with respect to diesel fuel. In 1993, the diesel fuel tax collection rules generally were conformed to those for gasoline. Following these changes, the IRS testified before the Subcommittee on Oversight of the Committee on Ways and Means that the 1993 changes to the diesel fuel tax collection rules had increased tax receipts by nearly $1 billion (after adjustments for unrelated factors) during the first year after the collection rules were changed.

As reports of diesel fuel tax evasion have decreased, the IRS has reported increasing use of kerosene as a highway motor fuel, without payment of tax that currently is due. As described above, small amounts of kerosene typically are blended with diesel fuel during periods of colder

temperatures to prevent gelling of the fuel. However, the IRS has recently reported that kerosene terminal removals have increased by as much as 300 percent in some Southwestern states since the 1993 curbs on diesel fuel tax evasion. The IRS reports that not only is this increased usage being found in States where the extreme weather conditions necessitating blending do not occur, but other examples of significantly higher kerosene/diesel fuel blends have been discovered in trucks in other areas. Proponents of the Administration proposal suggest that extending the current gasoline and diesel fuel excise tax collection rules to kerosene would curb this tax evasion as previously was accomplished with the gasoline and diesel fuel taxes.

Opponents of extending the diesel fuel tax collection rules to kerosene suggest that use of kerosene to evade motor fuels taxes is not geographically uniform and that areas where the problem does not exist should not be burdened to eliminate potential problems elsewhere. These persons further suggest that an undue burden would be imposed on consumers using kerosene for nontaxable uses such as heating oil (including blends of diesel fuel and kerosene used as heating oil) and on wholesale suppliers of kerosene used in nontaxable uses if they were required to use dyed kerosene or seek refunds of tax paid at earlier points in the distribution chain on undyed kerosene. These persons also raise safety concerns if consumers chose to purchase untaxed, dyed kerosene to use in space heaters. (The Administration proposal addresses the safety concern arguments through vendor refunds similar to those used in the case of farmers and State and local governments to prevent those entities from having to purchase diesel fuel at tax-inclusive prices.)