DESCRIPTION OF POSSIBLE COMMITTEE AMENDMENT PROPOSED BY CHAIRMAN ROSTENKOWSKI TO H.R. 4333 (THE TECHNICAL CORRECTIONS ACT OF 1988)

Prepared by the Staff

of the

Joint Committee on Taxation

June 21, 1988

JCX-11-88

CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of a possible committee amendment to be offered by Chairman Rostenkowski to H.R. 4333 (Technical Corrections Act of 1988).[2]

This document includes descriptions of the following:

(1) Ways and Means Subcommittee proposals;

(2) Proposals by other House committees;

(3) Time-sensitive simplification and clarification proposals (including additional technical corrections);[3]

(4) Extensions and modifications of expiring tax provisions (and modification of diesel fuel excise tax collection procedures); and

(5) Revenue raisers.

A separate document (JCX-10-88) provides revenue estimates for fiscal years 1988-1991 of the provisions of the proposed committee amendment to H.R. 4333.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Possible Committee Amendment by Chairman Rostenkowski to H.R. 4333 (The Technical Corrections Act of 1988) (JCX-11-88), June 21, 1988.

[2] For a description of H.R. 4333 as introduced on March 31, 1988, see Joint Committee on Taxation, Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238) (JCS-10-88), March 31, 1988.

[3] Under the Chairman's amendment, technical corrections to Titles I and IV of the Employee Retirement Income Act of 1974 (ERISA) or to the Public Health Service Act, as well as related corresponding amendments to the Internal Revenue Code, would be deleted from H.R. 4333 and included in a separate bill (H.R. 4845, introduced by Chairman Rostenkowski on June 16, 1988). (For a description of the Chairman's proposed committee amendment to H.R. 4845, see JCX-12-88.)

PART ONE: WAYS AND MEANS SUBCOMMITTEE PROPOSALS

A. Public Assistance and Unemployment Compensation Subcommittee

1. AFDC quality control

Present Law

The Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1985 (P.L. 99-272) prohibits the Department of Health and Human Services from reducing AFDC payments to States for excess errors identified by the AFDC quality control system. This prohibition extends to July 1, 1988.

In addition, COBRA also requires that two studies be conducted -- by the Secretary of Health and Human Services and the National Academy of Sciences -- of the current quality control system. These studies are to examine how to best operate the quality control system to improve program administration as well as to provide reasonable data on which to penalize States with excessive levels of erroneous payments. The National Academy of Sciences study was received by the Committee in February 1988; the HHS study was received in April 1988.

Table 1 illustrates the pending and projected sanction amounts and the HHS and CBO schedule for collecting these funds under current law.

TABLE 1.-AFDC SANCTION AMOUNTS AND ESTIMATED COLLECTION SCHEDULES

Years errors were made	Estimated sanction amount (in millions)	HHS and CBO projected schedules for collecting sanctions	
		HHS estimate	CBO estimate
Fiscal year:			
1981	*$69		
1982	96		
1983	184		
1984	230		
1985	248	0	0
1986	355	0	0
1987	300	0	0
1988	274	0	0
1989	251	$349	0
1990	222	834	$46
1991	201	825	342

TABLE 1. CONTINUED--

Years errors were made	Estimated sanction amount (in millions)	HHS and CBO projected schedules for collecting sanctions	
		HHS estimate	CBO estimate
Fiscal year:			
1992	178	222	606
1993	153	201	184
Total	2,761	2,431	1,178

*Disallowance notices issued to States. Amount has been reduced to reflect waivers by Secretary of HHS.

Source: Department of Health and Human Services and Congressional Budget Office. Compiled by committee staff.

Subcommittee Recommendation

The moratorium on the collection of quality control disallowances would be extended for one year, the collection of error rate data and review of State waiver requests by the Grant Appeals Board would continue during the moratorium period, and HHS would be required to submit its recommendations for improving the quality control system by February 15, 1989. Specifically:

1. During the 12-month period beginning on July 1, 1988, the Secretary would be prohibited from imposing any reductions in payments to States pursuant to section 403(i) of the Social Security Act (or prior regulations), or pursuant to any comparable provision of law relating to the programs under Title IV-A of such Act in Puerto Rico, Guam, the Virgin Islands, American Samoa, or the Northern Mariana Islands. The moratorium would extend until July 1, 1989.

2. During the moratorium period, the Secretary and the States would be required to continue to operate the quality control systems in effect under Title IV-A of the Social Security Act, and to calculate the error rates, including the process of requesting and reviewing waivers.

3. Current law would be clarified to provide that the moratorium does not apply to the Departmental Grant Appeals Board and its review of the fiscal year 1981

disallowances or any subsequent disallowances. The Grant Appeals Board would be expected to consider appeals during the moratorium period. Collection of disallowances owed as a result of Grant Appeals Board decisions could not occur during the moratorium period.

4. The requirement, in current law (section 12302(c) of COBRA), that the Secretary publish regulations on restructuring the quality control systems to reflect the studies would be replaced with a requirement that the Secretary submit to the Congress, by February 15, 1989, its recommendations for a revised quality control system.

Effective Date

The provision would take effect on July 1, 1988.

2. Foster care independent living initiatives

Present Law

The Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272) authorized funds for State foster care independent living services programs for fiscal year 1987 and fiscal year 1988. These programs are designed to help children in foster care who are age 16 or older make the transition from foster care to independence.

Foster care children who are eligible for services under the program are those who are eligible under Title IV-E for Federally-assisted foster care maintenance payments. Eligibility for Title IV-E is limited to those foster care children who would have been eligible for AFDC before they were removed from their home and placed in foster care.

The Secretary of Health and Human Services is required to provide Congress with a report on the program by July 1, 1988. The authorization level for this entitlement is $45 million for each of the two fiscal years. States did not begin receiving funds under the program until July 1987.

Subcommittee Recommendation

The current authority for State independent living initiatives would be extended for one year with an authorization level of $45 million. The following additional changes would be made:

1. States would be permitted to spend fiscal year 1987 carry-over funds in fiscal year 1989.

2. In addition to children who are eligible under the Title IV-E foster care maintenance payment program, States would be permitted to use funds under the foster care independent living program for services to any or all other children in foster care under the responsibility of the State. Funds could not be used for the provision of room and board.

3. States would be permitted to provide for a transition period of independent living program eligibility for 6 months after youth leaves the foster care home or institution. These services might include activities such as training in daily budgeting, help in locating and maintaining housing, career planning, vocational training, services aimed at enabling participants to complete high school, provision of mentors, peer support groups, individual and group counseling, and resource and referral services.

4. The definition of case review system would be modified to clarify that the 18-month dispositional hearing may also consider issues relating to independent living.

5. The State report would be due on January 1, 1989, and a Federal report would be due on March 1, 1989.

Effective Date

The authority for States to include non-AFDC foster care children in the independent living program would be effective on enactment. The remaining provisions would take effect on October 1, 1988.

3. Due dates for self-employment demonstration project reports

<u>Present Law</u>

The Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) authorized self-employment demonstration projects in three States. The law requires two reports to Congress on these projects: (1) an interim report is due no later than two years after the date of enactment; and (2) a final report is due no later than four years after the date of enactment.

Subcommittee Recommendation

The interim and final reports would be required to be submitted three years and six years, respectively, after the date of enactment.

B. Social Security Subcommittee

1. Subcommittee Recommendations -- Minor and Technical Amendments to the Social Security Act

a. Interim Disability Benefits in Cases of Delayed Final Decisions

Present Law

If, upon appeal, an individual receives an unfavorable determination regarding disability benefits from an Administrative Law Judge (ALJ), he or she may appeal the ALJ's decision to the Social Security Administration's Appeals Council. If, on the other hand, the individual receives a favorable determination from the ALJ, the Appeals Council may review the determination on its "own motion." Interim disability benefits are not paid while a case is under review by the Appeals Council.

Subcommittee Recommendation

In any disability case under Title II or Title XVI of the Social Security Act in which an ALJ has made a decision favorable to the individual and the Appeals Council has not rendered a final decision within 110 days, interim benefits would be provided to the individual. (Delays in excess of 20 days caused by or on behalf of the claimant would not count in determining the 110 day period.) These benefits would begin with the month before the month in which the 110-day period expired, and would not be considered overpayments if eligibility were subsequently denied, unless the benefits were fraudulently obtained.

Effective Date

The provision would be effective with respect to favorable ALJ decisions made 180 days or more after enactment.

b. Application of Earnings Test in Year of Individual's Death

Present Law

A social security beneficiary under age 70 with earnings in excess of certain thresholds is subject to a $1 reduction in benefits for every $2 earned over the exempt amount.

The annual exempt amount under the earnings test is lower for beneficiaries under age 65 than for those 65-69. This year the exempt amount for those under age 65 is $6120, and the age 65-69 exempt amount is $8400. Thus, beneficiaries under age 65 begin to lose benefits at a lower earnings level than beneficiaries aged 65-69.

If a beneficiary dies, the annual exempt amount applicable at the time of death is prorated based on the number of months that he or she lived during the year. In addition, the higher exempt amount is applicable in the year a beneficiary reaches age 65, regardless of when during the year the beneficiary turns 65. If the beneficiary dies after his or her 65th birthday but still in the same year, the higher exempt amount applies. If, however, a beneficiary dies at age 64 in the year that he or she would have turned 65, the lower exempt amount applies. This may cause the benefits of an individual who reasonably expected to live until the end of the year, or reach 65 during the year, to be subject either to the prorated threshold or the lower threshold. This would, in some cases, necessitate the return of benefit overpayments by the beneficiary's estate.

Subcommittee Recommendation

The annual exempt amount would not be prorated in the year of death. In addition, the higher annual exempt amount for beneficiaries age 65-69 would apply to people who die before they reach 65 in the year that they otherwise would have attained age 65.

Effective Date

The provision would be effective with respect to deaths after the date of enactment.

c. Exemption from Reduction in "Windfall" Benefit

Present Law

Under the so-called "windfall" benefit provision of the Social Security Amendments of 1983, social security benefits are generally reduced for workers who also have pensions from work that was not covered under social security (e.g., work under the Federal Civil Service Retirement System). Under the regular, weighted benefit formula, benefits are determined by applying a set of declining percentages to average indexed monthly earnings. For workers who reach age 62 in 1988, a worker's basic benefit is equal to 90 percent of the first $319 of average indexed monthly earnings, 32 percent of earnings from $319 to $1922, and 15 percent of earnings above $1922. The formula applicable to those with pensions from non-covered employment substitutes 40 percent for the 90-percent factor in the first bracket. (The second and third factors remain the same.) The resulting reduction in the worker's social security benefit is limited to one-half the amount of the non-covered pension.

The new law is being phased in over a 5-year period, beginning with those persons first eligible for social security benefits in 1986.

Workers who have 30 years or more of social security coverage are fully exempt from this treatment. For workers who have 26-29 years of coverage, the percentage in the first bracket in the formula increases by 10 percentage points for each year over 25, as illustrated below:

Years of social security coverage	First factor in formula (percent)
25 or fewer	40
26	50
27	60
28	70
29	80
30 or more	90

Subcommittee Recommendation

The years of social security coverage required in order for an individual to be exempt from the windfall benefit formula would be lowered from 30 to 25 years. Similarly, the years of coverage at which the formula gradually takes effect would be scaled back, as illustrated below:

Years of social security coverage	First factor in formula (percent)
20 or fewer	40
21	50
22	60
23	70
24	80
25 or more	90

Effective Date

The provision would be effective for benefits payable for months after December, 1988.

d. <u>Denial of Benefits to Individuals Deported or Ordered Deported on the Basis of Association with the Nazi Government of Germany During World War II</u>

<u>Present Law</u>

People who are deported for violating specified provisions of the Immigration and Nationality Act lose their social security benefits. The list of provisions for which people are denied benefits does not, however, include paragraph 19 of such Act. Paragraph 19, which was added to the Immigration and Nationality Act in 1978, pertains to people deported for certain activities in association with the Nazi government of Germany during World War II.

<u>Subcommittee Recommendation</u>

Benefits to individuals deported as Nazi war criminals under paragraph 19 of the Immigration and Nationality Act would be terminated.

<u>Effective Date</u>

The provision would apply only in the case of deportations occurring, and final orders of deportation issued, on or after the date of enactment, and only with respect to benefits beginning on or after such date.

e. Modification in the Term of Office of Public Members of the Boards of Trustees

Present Law

The Boards of Trustees of the Social Security Trust Funds are composed of the Secretaries of the Treasury, Labor, Health and Human Services, and two members of the public. The members of the public are nominated by the President and confirmed by the Senate. The law specifies that their term of service is for four years, but is otherwise silent on the length of term for a public member appointed to fill a vacancy left by another public member who leaves before the end of his or her term. The law is likewise silent on whether a public member is permitted to serve after the expiration of his or her term until a successor has taken office.

Subcommittee Recommendation

A public member appointed to fill a vacancy occurring before the end of a term would be appointed only for the remainder of such term. A public member, whether appointed for a full term or appointed to fill an unexpired term, would be permitted to serve after the expiration of that term until a successor has taken office.

Effective Date

The provision would be effective upon enactment.

f. Continuation of Disability Benefits During Appeal

Present Law

A disability insurance beneficiary who is determined to be no longer disabled may appeal the determination sequentially through three appellate levels within the Social Security Administration (SSA): a reconsideration, usually conducted by the State Disability Determination Service that rendered the initial unfavorable determination; a hearing before an SSA administrative law judge (ALJ); and a review by a member of SSA's Appeals Council.

The beneficiary has the option of having his or her benefits continued through the hearing stage of appeal. If the earlier unfavorable determinations are upheld by the ALJ, the benefits are subject to recovery by the agency. (If an appeal is made in good faith, benefit repayment may be waived.) Medicare eligibility is also continued, but Medicare benefits are not subject to recovery.

The Omnibus Budget Reconciliation Act of 1987 extended this provision for one year. The Act authorized the payment of interim benefits to persons in the process of appealing termination decisions made before January 1, 1989. Such payments may continue through June 30, 1989 (i.e., through the July 1989 check).

Subcommittee Recommendation

The period in which benefits may be paid and Medicare eligibility continued while an appeal is in progress would be extended for one additional year. Upon application by the beneficiary, benefits would be paid while an appeal is in progress with respect to unfavorable determinations made on or before December 31, 1989 and would be continued through June 1990 (i.e., through the July 1990 check).

The provision would be extended pending a report from the Secretary of Health and Human Services to the Committee on Ways and Means and the Committee on Finance. The report is to assess the impact of the continuation of benefits on the Social Security and Medicare Trust Funds and the rate of appeals of disability determinations to ALJs.

Effective Date

The provision would be effective with respect to unfavorable decisions made on or before December 31, 1989.

g. Extend Social Security Exemption for Members of Certain Religious Faiths

Present Law

Self-employed workers may claim an exemption from social security coverage if they belong to a recognized religious sect or division whose teachings lead them to oppose acceptance of public or private insurance benefits. Employees who belong to such religious sects, however, are required to participate in social security.

Subcommittee Recommendation

The provision would extend the current law treatment of the self-employed to employees in cases where both the employee and the employer are members of a qualifying religious sect or division.

Effective Date

The provision would apply to taxable years beginning on or after January 1, 1989.

h. Use of Social Security Numbers to Locate Blood Donors with AIDS

Present Law

Government agencies may require individuals to furnish social security numbers (SSNs) only for certain specified purposes. States are authorized to require SSNs to administer tax, public assistance, drivers' license or motor vehicle registration laws.

Subcommittee Recommendation

States or authorized blood donor facilities (those licensed or registered with the Food and Drug Administration, such as the Red Cross) would be permitted to require donors to furnish social security numbers. The SSN would be available to locate the address of a blood donor found to be carrying the virus for acquired immune deficiency syndrome (AIDS), for the sole purpose of informing the blood donor of the possible need for medical care and treatment.

The provision protects blood donors by permitting access to the address information only to State agencies and blood donor facilities meeting requirements for confidentiality and security.

Effective Date

The provision would be effective upon enactment.

i. Payment of Lump Sum Death Benefits to Surviving Spouse

Present Law

A lump sum death payment of $255 is payable on the death of an insured worker to a surviving spouse who is living with the worker at the time of the worker's death or who is eligible to receive a monthly survivor's benefit at the time of the worker's death. If there is no eligible spouse, the lump sum death payment is payable to a child of the deceased worker who is eligible to receive monthly benefits as a surviving child.

If the widow(er) dies before making application for the lump sum payment or dies before negotiating the benefit check, no lump sum death benefit is payable.

Subcommittee Recommendation

The provision would permit the legal representative of the estate of a deceased widow(er) to claim the lump sum payment in cases in which the otherwise eligible widow(er) dies before having both received and negotiated such payment. Where the legal representative of the estate is a State or political subdivision of a State, the lump sum benefit would not be payable.

Effective Date

The provision would be effective with respect to deaths of widow(er)s occurring on or after January 1, 1989.

j. <u>Requirement of Social Security Number as a Condition for Receipt of Social Security Benefits</u>

<u>Present Law</u>

Applicants for social security benefits are not required to have social security numbers in order to receive benefits. The absence of a social security number for auxiliary and survivor beneficiaries hampers monitoring which might detect duplicate payments, earnings, and entitlement to other benefits.

SSA currently requests that applicants voluntarily provide their social security numbers. Under Federal law, recipients of Aid to Families with Dependent Children, Supplemental Security Income, and Veterans' Assistance benefits are currently required to provide their social security numbers in order to receive benefits under those programs.

<u>Subcommittee Recommendation</u>

Individuals would be required to furnish a social security number for receipt of social security benefits. Those lacking a social security number would be required to make proper application for one. Beneficiaries currently on the rolls would not be subject to this requirement. However, they would be encouraged to provide a correct social security number or to apply for a number if one had not previously been assigned.

<u>Effective Date</u>

The provision would be effective with respect to benefit entitlements commencing after the sixth month following the month of enactment.

k. Substitution of Certificate of Election for Application to Establish Entitlement for Certain Reduced Widow(er)'s Benefits

Present Law

An individual who (1) is receiving a combination of a reduced spouse's benefit and either retirement or disability benefits on his or her own record and (2) is between the ages of 62 and 65 when his or her spouse dies, must file an application to receive reduced widow(er)'s benefits.

Those who are over age 65 when the worker dies and who are receiving spouses' benefits or those age 62-65 when the worker dies who are not entitled to their own retirement or disability benefits may receive reduced widow(er)s' benefits by filing a certificate of election rather than an application.

An application for a reduced widow(er)'s benefit is generally not effective for months before the month of filing. Thus, a break in entitlement could occur if the application were not filed in a timely fashion.

Subcommittee Recommendation

An individual who is receiving both a reduced spouse's benefit and a retirement or disability benefit and who is between the ages of 62 and 65 when his or her spouse dies, could receive a reduced widow(er)'s benefit by filing a certificate of election. A certificate of election would be effective for up to 12 months before it is filed.

Effective Date

The provision would be effective with respect to benefits payable based on the record of individuals who die after the month of enactment.

1. Calculation of Windfall Benefit Guarantee Amount in Month of Concurrent Entitlement Rather Than Concurrent Eligibility

Present Law

Under the windfall benefit provision, a special formula is used to compute the social security benefits of workers who are also eligible for pensions based on non-covered employment. The "windfall guarantee" assures that the windfall formula will not reduce the social security benefit by more than one-half the amount of the non-covered pension. The amount of the non-covered pension is currently the amount payable in the first month the individual is eligible for both the pension and social security (i.e., the month of concurrent eligibility).

When an individual applies for social security benefits, the Social Security Administration must ask the individual's pension administrator to compute a pension amount that would have been payable at the date of first concurrent eligibility for both the pension and social security (usually age 62) regardless of the pension amount which the person will actually receive upon entitlement. Processing delays and errors can occur when pension administrators make this fictitious computation of the pension amount.

Subcommittee Recommendation

The amount of the pension considered when determining the windfall guarantee would be the amount payable in the first month of concurrent entitlement to both social security and the pension from non-covered employment.

Effective Date

The provision would be effective for benefits based on applications filed on or after January 1, 1989.

m. Consolidation of Reports on Continuing Disability Reviews in the Social Security Administration's Annual Report to Congress

Present Law

The Secretary of Health and Human Services is required to make two types of reports on continuing disability reviews to the Senate Committee on Finance and the House Committee on Ways and Means. The first is a semi-annual report on the results of continuing disability reviews. The second is an annual report on the appropriate number of disability cases to be reviewed in each state.

Subcommittee Recommendation

These two types of reports on continuing disability reviews would be consolidated into one annual report to be made to the Senate Committee on Finance and the House Committee on Ways and Means. The report would remain separate from the Social Security Administration's Annual Report to the Congress.

Effective Date

This provision would be effective with respect to reports required to be submitted after the date of enactment.

2. Additional Social Security Technical Corrections

a. Group-term Life Insurance

Present Law

The Omnibus Budget Reconciliation Act of 1987 required the cost of employer-provided group term life insurance to be included in wages for FICA tax purposes if it is includible for gross income tax purposes. Under current law, it is includible for gross income tax purposes to the extent that coverage exceeds $50,000.

Description of Proposal

The amendment would exclude from FICA tax group-term life insurance provided to individuals who separated from service before January 1, 1989. This provision recognizes that employers may have difficulty collecting FICA tax from employees who have already separated from service and retired.

Effective Date

The provision would be effective with respect to separations from service on or after January 1, 1989.

b. Corporate Directors

Present Law

The Omnibus Budget Reconciliation Act of 1987 provides that corporate directors' earnings shall be treated as received when earned, regardless of when actually paid, for purposes of both the social security tax (SECA) and the social security retirement test.

Description of Proposal

Directors' earnings would be treated as received when earned only for purposes of the social security retirement test.

Effective Date

The provision would be effective as if it had been included in OBRA of 1987 at the time of its enactment.

c. Government Pension Offset

Present Law

The Omnibus Budget Reconciliation Act of 1987 permitted Federal employees who joined the new Federal Employees Retirement System (FERS) during the open enrollment period (July 1, 1987 through December 31, 1987) to be exempt from the government pension offset. Under the government pension offset, the social security spouse's or surviving spouse's benefit is reduced by two-thirds of the amount of any government pension received by the individual.

Description of Proposal

The provision would make it clear that anyone who elected FERS on or before December 31, 1987 would be exempt from the government pension offset even if that person retired from the government service before the FERS coverage became effective.

In addition, the provision would make it clear that the 1987 Act applies not only to Federal employees who join FERS by electing to become subject to chapter 84 of title 5, United States Code, but also to foreign service employees who join FERS by electing to become subject to chapter 22 of title 1, United States Code.

Effective Date

The provisions would be effective as if they had been included in OBRA of 1987 at the time of its enactment.

d. Blood Donor Locator Service

Present Law

The Minor and Technical Amendments approved by the Social Security Subcommittee on March 1, 1988 establish a Blood Donor Locator Service.

Description of Proposal

The provision would strengthen the confidentiality protections for blood donor records and would require blood donation facilities to provide for counseling of donors located through the service.

Effective Date

The provision would be effective upon enactment.

e. <u>Clarification Regarding Social Security Coverage for Certain Senior Civil Servants</u>

<u>Present Law</u>

(1) The Social Security Amendments of 1983 provided mandatory social security coverage for presidential appointees as well as the President, Members of Congress, federal judges, and certain executive level civil servants.

However, Section 205(p) of the Social Security Act provides that the Secretary of Health and Human Services shall accept the determination of the head of a federal agency as to whether a federal employee has performed service, as to the periods of such services and as to the amount of remuneration which constitute wages. The Office of Personnel Management has interpreted this section to mean that a federal agency may determine whether or not an employee's service constitutes social security covered employment. Because the civil service statute permits career SES employees to retain their pay, rank and retirement plan when they move to a presidential appointment, OPM has interpreted section 205(p) to mean that such individuals may avoid social security coverage in contravention of the coverage provisions of the Social Security Act (while retaining coverage under the old Civil Service Retirement System).

No other individuals receive such treatment. For example, individuals in the private sector or career civil servants in a non-SES job are mandatorily covered by social security when they take a presidential appointment.

(2) Due to an oversight in current law, when an individual accepts a mandatorily covered federal job and subsequently returns to his or her previous job or another non-covered federal job, he or she loses social security coverage.

<u>Description of Proposal</u>

(1) The provision would clarify that the Secretary of HHS, not the head of any other federal agency, has the authority to make the final determination as to whether an individual's services constitute social security covered employment. This is intended to assure that all presidential appointees are covered under social security as provided in the coverage provisions of the Social Security Act.

(2) In addition, the provision would clarify that any civil servant who becomes covered by social security as a result of taking a mandatorily covered federal job would retain social security coverage in any subsequent federal job.

<u>Effective Date</u>

(1) The provision would be effective January 1, 1989.
(2) The provision would be effective upon enactment.

PART TWO: PROPOSALS BY OTHER HOUSE COMMITTEES

A. Treatment of Enjebi Community Trust Fund Earnings and Distributions

Present Law

The Enjebi Community Trust Fund was established in the Compact of Free Association Act of 1985 (P.L. 99-239) to finance the rehabilitation of Enjebi Island in the Enewetak Atoll. Enjebi was used by the United States as ground zero for nuclear weapons tests in the 1940's and 1950's. Because radiation is still too high to resettle Enjebi, a fund has been established to conduct the cleanup once it is feasible for the people to return. The fund is to have a principal amount of $10,000,000.

Description of Proposal

Earnings on and distributions from the Enjebi Community Trust Fund would be exempt from any form of Federal, State, or local taxation.

Reasons for Change

The Enjebi Community Trust Fund should be allowed to grow from the proceeds of investment earnings on a tax-free basis in order to provide an appropriate amount for the eventual rehabilitation of Enjebi Island. An exemption was provided in 1982 for a similar trust fund for Bikini Island.

Effective Date

The provision would be effective for all taxable years.

B. Extension of Commencement Date of Oil Spill Liability Trust Fund and Tax on Petroleum

Present Law

Omnibus Budget Reconciliation Act of 1986

The 1986 Budget Reconciliation Act established the Oil Spill Liability Trust Fund in the Internal Revenue Code and a tax of 1.3 cents per barrel on crude oil and refined products subject to the Superfund petroleum tax.

The Trust Fund and tax provisions were to have taken effect on the commencement date. The commencement date was to occur on the first day of the first calendar month beginning more than 30 days after the enactment of a law before September 1, 1987 authorizing an oil spill liability program. Since authorizing legislation was not enacted by September 1, 1987, the Oil Spill Liability Trust Fund and tax provisions of the 1986 Budget Reconciliation Act will not take effect.

Superfund petroleum tax

Superfund taxes of 8.2 cents per barrel for domestic crude oil and 11.7 cents per barrel for imported petroleum products are imposed on the receipt of crude oil at a U.S. refinery, the import of petroleum products and, if the tax has not already been paid, on the use or export of domestically produced oil.

Description of Proposal

The commencement date of the Oil Spill Liability Trust Fund and petroleum tax would be extended so that the trust fund and tax would take effect if qualified legislation authorizing an oil spill liability program is enacted by December 31, 1990.

Reason for Change

Extending the commencement date of the Oil Spill Liability Trust Fund and petroleum tax would provide additional time for the enactment of authorizing legislation during the 100th Congress.

Effective Date

The provision would be effective upon date of enactment.

PART THREE: TIME-SENSITIVE SIMPLIFICATION AND CLARIFICATION PROPOSALS

A. Additional Technical Corrections

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Technical Amendments to the Tax Reform Act of 1986

I. Capital Cost Provisions (Title II of the 1986 Act)

Depreciation and Investment Tax Credit

An error in stating the amount of investment credit eligible for a transitional exception included in the Reform Act for a Spray Cotton Mills facility would be corrected.

Rehabilitation Credit

A typographical error in the specification of a plat number in one of the items listed in section 102(k)(3) of the introduced bill would be corrected.

II. Capital Gains and Losses (Title III of the 1986 Act)

The provision of prior law limiting the deduction for net capital losses of noncorporate taxpayers to taxable income would be reinstated. This provision is determined to have a revenue effect.

III. Tax Shelters; Interest Expense (Title V of the 1986 Act)

The provision in the bill (sec. 105(c)(11)) which treats pre-1987 investment interest carryovers attributable to net lease property as subject to the passive activity rules rather than as investment interest would apply only if the taxpayer elects.

IV. Corporate Tax Provisions (Title VI of the 1986 Act)

A. Special Limitations on Net Operating Loss and Other Carryforwards

1. Value of loss corporation: Special rule in the case of redemption or contraction.--The amendment would provide that the statutory extension of the rules for redemptions to other corporate contractions applies only to ownership changes after June 10, 1987.

2. Built-in gains and losses: Treatment of certain deductions.--The amendment would clarify that, under regulations, any amount allowable as a deduction during the recognition period but attributable to periods before the change date is treated as a recognized built-in loss.

3. <u>Computation of 25-percent threshold for built-in gains and losses</u>.

a. The amendment would provide regulatory authority to take cash items and marketable securities into account for purposes of the threshold computation.

b. For ownership changes occurring on or after June 21, 1988, the amendment would also provide that redemptions or other corporate contractions occurring in connection with an ownership change are taken into account for purposes of the threshold computation only to the extent provided in regulations.

4. <u>Bankruptcy proceedings</u>.--The amendment would clarify that the disallowance of an interest deduction for interest paid to creditors during the three years prior to the year of the ownership change applies for purposes of computing pre-change excess credits, as well as pre-change losses.

B. <u>Recognition of Gain or Loss on Liquidating Sales and Distributions of Property (General Utilities)</u>

1. <u>Tax imposed on certain built-in gains of S corporations</u>.--The amendment would clarify that amounts that are allowable as a deduction during the recognition period but that are attributable to periods before the first S corporation taxable year are treated as recognized built-in losses in the year of the deduction.

2. <u>Certain transfers to foreign corporations</u>.--

a. <u>Effective date</u>.--The amendment would provide that the technical correction relating to transfers of property to a foreign corporation that would otherwise qualify as a tax-free reorganization applies only to transactions occurring after June 10, 1987.

b. <u>Conditions for relief</u>.--The amendment would also modify the conditions under which relief from full immediate tax may be granted. In general, relief would be granted where 5 or fewer U.S. corporations owned at least 80 percent of the stock of the transferor corporation prior to the transaction, subject to certain basis adjustments and other conditions to prevent the removal of corporate appreciation from U.S. taxing jurisdiction.

3. <u>Certain liquidating distributions of installment obligations by S corporations</u>.--The amendment would clarify that no gain or loss with respect to a liquidating distribution of an installment obligation will be recognized by a distributing S corporation except for purposes of any tax imposed by subchapter S.

4. Certain distributions.--For transfers on or after June 21, 1988, the amendment would clarify that the transfer of property by a corporation to its shareholder in a transaction under section 351(b) (certain corporate contributions) is taxed as a nonliquidating distribution.

C. Amortizable Bond Premium

1. Effective date.--The amendment would provide that the provision of the bill (sec. 106(j)(1)) relating to the treatment of bond premium as a reduction of interest income on the bond applies to bonds acquired after December 31, 1987, unless the taxpayer elects to have the amendment apply to bonds acquired after October 22, 1986.

2. Basis reduction.--The amendment would clarify that basis reduction is required for amounts of amortizable bond premium applied to reduce interest payments under the provision.

D. Regulated Investment Companies (RICs)

1. Time certain dividends taken into account.--The provision treating certain dividends declared in October, November and December as paid in the year of declaration would be effective for dividends declared on or after January 1, 1988.

E. Real Estate Investment Trusts (REITs)

1. Time certain dividends taken into account.--The provision treating certain dividends declared in October, November and December as paid in the year of declaration would be effective for dividends declared on or after January 1, 1988.

2. Treatment of amounts based on income or profit as interest.--Gain on the disposition of real property would not change the characterization of amounts otherwise qualifying as interest for purposes of the 95-percent and 75-percent tests.

F. Real Estate Mortgage Investment Conduits (REMICs)

1. Disqualified organization.--An organization will not be treated as an instrumentality of the United States or of any State or political subdivision thereof if all its activities are subject to tax, and, with the exception of the Federal Home Loan Mortgage Corporation, a majority of its board of directors is not selected by such governmental unit.

2. Tax on pass-through entities.--An entity would be

relieved of liability for the tax imposed on pass-through entities with respect to an interest in such entity if the holder of record of the interest furnishes an affidavit that it is not a disqualified organization and during the period the pass-through entity lacks knowledge that the affidavit is false.

3. Effective date of transfer and pass-through taxes.--The bill would clarify that regulated investment companies, real estate investment trusts, common trust funds, or publicly traded partnerships are entitled to the general effective date and a special effective date for taxable years beginning after January 1, 1989.

4. Reporting.--The bill would clarify that amounts includible with respect to regular interests would be reported when accrued.

5. Determination of net operating loss.--Excess inclusions would be disregarded in determining net operating losses, net operating loss carryforwards and net operating loss carrybacks.

V. Accounting Provisions (Title VIII of the 1986 Act)

1. Limitation on the use of the cash method of accounting.--Clarification would be provided that an S corporation is not treated as a tax shelter under the public offering test by reason of being required to file a notice of exemption from registration with a State agency if all corporations that are organized in the State or that offer securities for sale in the State are required to register or file a notice of exemption from registration.

2. Capitalization rules: simplified method for certain tangible personal property.--Because the Treasury Department has provided simplified rules for deducting business expenses of individuals who are mainly responsible for the creation of a work of art, the grant of regulatory authority contained in the introduced bill would be removed.

3. Taxable years of common trust funds.--The effective date of the change requiring common trust funds to adopt a calendar year would be postponed one year (i.e., the change would apply to taxable years beginning after December 31, 1987).

4. Repeal of installment method for revolving credit installment obligations.--The contraction rule for revolving credit installment obligations would be applied by treating obligations that are disposed of to an unrelated party on or before October 26, 1987, as not outstanding as of the close

of the taxpayer's last taxable year beginning before January 1, 1987. For this purpose, obligations disposed of pursuant to a written contract that was binding on October 26, 1987, and at all times thereafter until the date of disposition shall be considered disposed of on or before October 26, 1987.

VI. Insurance Provisions (Title X of the 1986 Act)

1. Structured settlements.--The amendment would provide an exception to the required distribution rules for annuity contracts that are qualified funding assets under structured settlement agreements without regard to whether a qualified assignment has occurred.

2. Market discount bonds.--The committee report to the bill would provide rules for taking into account capital losses in determining the amount of gain that is subject to tax at a rate of 31.6 percent.

3. Election of small property and casualty companies to be taxed on investment income.--The amendment would clarify that a small property and casualty insurance company that elects to be taxed on its taxable investment income is subject to current tax on amounts subtracted from a protection against loss account.

VII. Pensions; Employee Benefits (Title XI of the 1986 Act)

1. Qualified plan coverage.--The amendment would clarify that an employee who has satisfied a qualified plan's age and service requirements but who has not attained the plan's entry date (sec. 410(a)(4)) is not taken into account for testing discrimination under section 410(b).

2. Dependent care assistance.--Under the amendment, the $5,000 limit on dependent care assistance under section 129 would apply on an accrual basis. The requirement that the employer report to an employee the dependent care assistance provided to the employee would be similarly modified to apply on an accrual basis. The reporting requirement would be further modified by requiring that the reporting be to the IRS in addition to the employee.

3. Distributions from eligible deferred compensation plans.--The bill provides that section 457(d)(9) does not permit in-service distributions from an eligible deferred compensation plan. Under the amendment, this provision of the bill would apply to years beginning after December 31, 1988.

4. Interest rate relating to minimum participation rule.--The bill establishes certain permissible interest

rates that apply for certain purposes in the case of a termination, asset transfer, or asset distribution with respect to a plan that would have failed to satisfy the requirements of the minimum participation rule (sec. 401(a)(26)) had the effective date of such rule been August 16, 1986. In determining such permissible rates, the bill disregards certain retroactive plan amendment with respect to nonhighly compensated employees. Under the amendment, such retroactive amendments would only be disregarded if adopted after October 26, 1987.

5. ERISA, etc., amendments.--Under the amendment, technical amendments to Titles I and IV of the Employee Retirement Income Security Act of 1974 (ERISA) or to the Public Health Service Act, as well as corresponding amendments to the Internal Revenue Code, and a correction of a date in a transition rule with respect to the effective date of the Multiemployer Pension Plan Amendments Act of 1980 would be deleted from H.R. 4333 and, except for the amendment to the Public Health Service Act, included in a separate bill (H.R. 4845). (See "Description of Possible Committee Amendment to Provisions of H.R. 4845: Pension Related Amendments," JCX-12-88.)

VIII. Foreign Tax Provisions (Title XII of the 1986 Act)

A. Foreign Tax Credit

1. Application of the separate foreign tax credit limitation for financial services income to de minimis amounts of foreign base company or subpart F insurance income.--The amendment would clarify that income that would be treated as financial services income but for the de minimis subpart F income exception will be financial services income for purposes of applying the separate foreign tax credit limitations.

B. Source Rules

1. Definition of intangible.--Under the amendment, the definition of intangible property, for purposes of applying the 1986 Act source rules applicable to income from the sale of an intangible, would be modified to include franchises.

C. Subpart F

1. Coordination of related person exceptions and the chain deficit rule.--Under the amendment, interest, rent, and royalty payments from a related person organized or created under the laws of the same country as the recipient would not qualify for the "same-country" exception from subpart F income to the extent that such payments may reduce subpart F income of either the payor or, because of the chain deficit rule, another entity.

D. U.S. Taxpayers

1. PFIC inclusions.--Under the amendment, a U.S. shareholder in a PFIC that is both a controlled foreign corporation and a qualified electing fund would not include in income U.S. source effectively connected earnings, unless those earnings were exempt from U.S. tax or subject to a reduced rate of U.S. tax under a treaty.

2. Coordination of PFIC and charitable lead trust rules.--The amendment would provide that if PFIC stock is held by a charitable lead trust (or other trust with respect to which a charitable deduction is allowable with respect to an interest (other than a remainder interest) in the trust), then under regulations the income from PFIC stock distributions and gains upon which deferred tax amounts are computed may be adjusted to take into account the charitable obligations of the trust.

3. Termination of election to defer tax payment.--In the case of a taxpayer who elects to defer the payment of an undistributed PFIC earnings tax liability with respect to the taxpayer's stock in a PFIC that is a qualified electing fund, the amendment would provide that under regulations the election may continue in effect in the event that the taxpayer disposes of the PFIC stock in certain nonrecognition transactions.

4. Coordination of PFIC and pooled income fund rules.--If the governing instrument of a pooled income fund allows no portion of any gain from a disposition of PFIC stock owned by the fund to be allocated to income beneficiaries of the fund, then under the amendment the fund would not be taxed on undistributed PFIC earnings under the rules governing PFICs that are qualified electing funds; and gains realized by the pooled income fund on the disposition of PFIC stock would not be subject to the interest charge rules applicable to PFICs that are not qualified electing funds.

5. Reduction of deferred tax amount by foreign tax credits.--The amendment would specify the method by which foreign taxes paid or deemed paid with respect to an excess distribution from a PFIC, or a sale or exchange of PFIC stock to which section 1248 would otherwise apply, will reduce the deferred tax amount due on the distribution or gain.

E. Foreign Taxpayers

1. Treaty reductions or exceptions to the branch profits tax.--The amendment would clarify that only provisions of income tax treaties can serve as the basis for a treaty-based reduction or elimination of branch profits tax.

2. Exclusion of international organizations from branch tax.--The amendment would clarify that international organizations, as defined in the Code, are not subject to either the branch level interest tax or the branch profits tax.

3. Withholding tax on foreign partners' share of effectively connected taxable income of a partnership.--The amendment would clarify that for purposes of the withholding tax provision, "effectively connected taxable income" is computed without taking into account items of income, gain, loss, or deduction to the extent such items are allocable under section 704 to any partner who is not a foreign partner.

F. Miscellaneous Foreign Provisions

1. Applicability of dividends received deduction to FSC distributions.--The amendment would provide that dividends from a foreign sales corporation (FSC) out of the FSC's investment income would qualify only for the 70/80 percent dividends received deduction, and not the 100 percent deduction.

G. 1984 Act Technical

1. Recognition of gain or loss upon transfers to nonresident aliens incident to divorce.--The amendment would expand the present law exception from the rule generally providing for nonrecognition of gain or loss on a transfer of property, incident to a divorce, from an individual to his or her current or former spouse. Under the amendment, nonrecognition would be denied on a transfer to a former spouse who is a nonresident alien. Under present law, nonrecognition is already denied in the case of a transfer to a current spouse who is a nonresident alien.

IX. Tax-Exempt Bonds (Title XIII of the 1986 Act)

1. An error in the amount of bonds eligible for a transitional exception included in the Reform Act for renovation of a District of Columbia stadium would be corrected.

2. An error in the description of the number of housing units to be included in a Howard University facility for which a transitional exception was included in the Reform Act would be corrected.

X. Trusts and Estates; Minor Children; Generation-Skipping Transfer Tax (Title XIV of the 1986 Act)

A. Taxation of Unearned Income of Minor Children

1. Different taxable years.--Except as provided in regulations, if a parent and child have different taxable years, the child's tax would be computed by reference to the parent's taxable year ending with or within the child's taxable year.

B. Generation-Skipping Transfer Tax

1. Taxable termination not to include direct skip.--The language in the bill providing that a taxable termination does not also include a transfer which is a direct skip would be deleted as unnecessary.

2. Special rules for certain inter vivos transfers.--The rule treating a reference to an individual as a reference to his spouse would apply except as provided in regulations.

3. Effective date for GST allocations made to property transferred as a result of death.--Any allocation of GST exemption to property transferred as a result of the transferor's death would be effective on and after the date of death.

4. Valuation date where GST exemption allocated after death.--The value of property not transferred as a result of death would be determined as of the date the GST allocation with respect to such property is filed.

5. Nontaxable gifts.--The rules governing certain direct skips which are nontaxable gifts would apply to transfers made after March 31, 1988.

6. Treatment of grandfathered portion.--The provision in the bill treating the grandfathered portions of a trust as separate trusts would be deleted as unnecessary.

7. $2 million exemption.--The distribution requirement for the $2 million exception would be met if income from the trust is distributed for the benefit of the grandchild after age 21.

XI. Miscellaneous Provisions (Title XVIII of the 1986 Act)

1. Controlled group of corporations.--The definition of a parent-subsidiary controlled group of corporations (sec. 1563) would be amended to provide for the attribution of stock held by partnerships, estates and trusts. The amendment would apply to taxable years beginning after date of enactment of the bill.

2. Freight forwarders.--The rule relating to the compensation of ocean freight forwarders would be deleted from the 1986 Act.

3. Effective date of technical amendments on title holding companies.--The effective date of the provisions of the Technical Corrections Bill relating to indirect interests in real property and the flow-through of the character of debt-financed income of title holding companies is postponed until transactions entered into after June 10, 1987.

Technical Amendments to Other Tax Legislation

I. Technical Amendments to the Revenue Act of 1987

A. Employee Benefit Provisions

1. Cafeteria plans.--Under the amendment, cafeteria plan participants who, prior to the enactment of the Revenue Act of 1987 (which disallowed overnight camp expenses as dependent care expenses), elected dependent care assistance for a period after 1987 would be entitled to receive reimbursement pursuant to such election for overnight camp expenses without disqualifying the cafeteria plan (even though such reimbursements are taxable).

2. Deduction rules.--The amendment would modify the special rules with respect to employer contributions upon plan termination or employer withdrawal from a plan (sec. 404(g)). The amendment would conform these special rules to certain rules included in the Revenue Act of 1987. Specifically, the amendment would delete the provision allowing an entity other than the employer to take a deduction for a contribution made with respect to an employee of such employer. This amendment would apply to contributions made with respect to terminations and withdrawals occurring after date of enactment.

3. ERISA, etc., amendments.--Under the amendment, technical amendments to Titles I and IV of the Employee Retirement Income Security Act of 1974 (ERISA) or to the Public Health Service Act, as well as corresponding amendments to the Internal Revenue Code, would be deleted from H.R. 4333 and, except for the amendments to the Public Health Service Act, included in a separate bill (H.R. 4845). (See "Description of Possible Committee Amendment to Provisions of H.R. 4845: Pension Related Amendments," JCX-12-88.)

B. Accounting Provisions

1. Nondealer real property installment obligations.--Clarification would be provided that in computing the interest charge on the deferred tax all persons treated as a single employer under section 52 would be treated as one person, except as otherwise provided in Treasury regulations.

C. Partnership Provisions

1. Treatment of certain partnership allocations for unrelated business tax.--The amendment would delete the

redundant provision governing allocations to partners other than qualified tax-exempt partners (sec. 514(c)(9)(E)(i)(I)). Thus, allocations exclusively among partners other than qualified tax-exempt partners would be treated as permitted allocations so long as such allocations have substantial economic effect, and do not give rise to a violation of the rules limiting allocations between qualified tax-exempt partners and other partners (sec. 514(c)(9)(E)).

2. Definition of qualifying passive-type income for publicly traded partnerships.--The definition of real property rents would be amended to provide a 5 percent de minimis rule for attribution of holdings to or from partnerships. The definition of qualifying income would be clarified to provide that qualifying income from minerals or natural resources is intended to cover depletable minerals or natural resources.

3. Application of qualifying passive-type income for formerly untraded partnerships.--The amendment would provide that the qualifying income requirements must be met for each year after which the partnership is publicly traded (as opposed to each year it is in existence), in order for such partnership not be treated as a corporation.

D. Corporate Tax Provisions

1. Computation of earnings and profits for purposes of intercorporate dividends and basis adjustments under consolidated return provisions (overruling of Woods Investment Co.).--The amendment would provide Treasury regulatory authority to permit a taxpayer election to reduce its basis in indebtedness of a corporation with respect to which there would have been an excess loss account, in certain cases where the bill (sec. 204(i)(1)(B)) requires negative basis treatment on the disposition of stock.

2. Mirror subsidiary transactions.--The amendment would modify the transition rule applicable to "mirror subsidiary" and related transactions, to clarify that the ownership of distributees may be aggregated (to the extent permitted by prior law) in the case of certain distributees whose ownership of the distributing corporation was indirect, through an intermediate corporation that goes out of existence in the transaction.

3. Limitation on use of preacquisition losses to offset built-in gains.--

a. Ordering rules for losses.--The amendment would clarify the order in which losses are used where losses are subject to limitation (under new section 384) because they may not be used to offset built-in gains.

b. Effective date.--For transactions occurring before March 31, 1988, the amendment would provide that a taxpayer could make an election to apply the limitations on the use of preacquisition losses to offset built-in gains not taking into account the provisions of the technical corrections bill.

4. Recapture of LIFO amount in the case of election by S corporation.--The amendment would provide that the tax attributable to LIFO recapture by reason of electing Subchapter S would not be included on the seller's consolidated return, notwithstanding that the income from the corporation's last taxable year as a C corporation would otherwise be included on the seller's consolidated return.

5. Greenmail excise tax.--The amendment would apply the provision that greenmail includes any consideration transferred by any person acting in concert with a corporation to acquire its stock only for transactions occurring on or after March 31, 1988.

E. Insurance Provisions

1. Reserves of life insurance companies.--The amendment would provide that, in computing life insurance reserves, certain amounts in the nature of interest are not taken into account beyond the end of the taxable year to the extent that the rate exceeds the greater of the prevailing State assumed interest rate or the applicable Federal interest rate. In addition, the amendment would provide that required interest for purposes of determining the company's and the policyholders' share of net investment income is determined by using the prevailing State assumed interest rate.

2. Foreign insurance companies.--The amendment would provide that the domestic investment yield and the worldwide current investment yield are determined on the basis of all of the assets of insurance companies rather than only those assets held for the production of investment income. In addition, the amendment would authorize the Treasury Department to prescribe separate domestic asset/liability percentages for certain types of property and casualty insurance companies. For this purpose, property and casualty insurance companies could be categorized based on the predominant type of business (e.g., short-tail, long-tail or reinsurance) of the company.

F. Estate and Gift Tax Provisions

Estate freezes.--These changes are made in order to clarify the statute and provide certainty to persons undertaking common business transactions. The provision in the pending technical corrections bill (H.R. 4333) and certain of the amendments listed below are determined to have a revenue effect.

a. Amendments to changes contained in H.R. 4333.--The provision in the pending technical corrections bill and the four amendments listed below would be effective for transfers made on or after June 21, 1988.

1. Prior gifts.--The amount of a gift deemed by virtue of a later transfer by either the original transferor or transferee would be reduced by the amount of any taxable gift resulting from the original transfer. Such amount would also be reduced by the amount of previous deemed gifts.

2. Terminations, lapses, etc.--Terminations, lapses, and other changes in interests in the enterprise would result in a deemed gift. One consequence of this amendment is that a deemed gift would occur upon the termination of an income interest in a grantor retained income trust.

3. Later transfer to original transferor.--The rule deeming a gift whenever the original transferor or transferee later transfers an interest in the enterprise would not apply where the transferee transfers the interest back to the original transferor.

4. Effect of continuing interest in property.--A transfer of property would not result in a deemed gift if the transferor or transferee retains a direct or indirect continuing interest in such property, for example by transferring the property to a holding company.

b. Changes in estate freeze provision as enacted.--

1. Receipt or retention of debt.--An amount would not be includible in a person's estate solely because that person received or retained certain debt lacking equity features. Such debt would have to meet specified requirements regarding term, interest rate, payment dates, voting rights and conversion.

2. Existence of sale, lease, or compensation agreement.--An amount would not be includible in a person's estate solely because that person retained an arms length agreement with the enterprise for the sale or use of property or the providing of services which did not otherwise give that person an interest in the enterprise.

3. Options.--An amount would not be includible in a person's estate solely because that person granted an option or, entered into some other agreement, to sell property at its fair market value at the time the option is exercised.

4. Retained income or rights.--The statute would be

clarified by deleting language requiring that the transferor's retained income or rights in the enterprise be a disproportionately large share of such income or rights in order for the provision to apply.

5. Treatment of spouse.--Regulatory authority would be granted to specify the circumstances in which an individual and his spouse would not be treated as one person.

6. Substantial interest test.--A substantial interest in an enterprise triggering the provision would exist if a person held such an interest either before or after the effective transfer. This change would be effective for transfers made on or after June 21, 1988.

7. Contribution.--The estate would be given the right to require that the transferee pay his or her share of estate tax attributable to operation of the freeze provision.

B. Employee Benefits

1. Sanction for violation of the health care continuation rules

Present Law

Under present law, certain group health plans are required to satisfy the health care continuation rules of section 162(k). In general, pursuant to these rules, an employer (or successor employer) is required to provide qualified beneficiaries with the opportunity to participate for a specified period in the employer's health plan despite the occurrence of a qualifying event that otherwise would have terminated such participation. In general, qualified beneficiaries are defined to include certain covered employees and certain family members of covered employees.

If a plan subject to the health care continuation rules fails to satisfy the rules, all deductions for expenses paid or incurred for group health plans by the employer maintaining such plan are disallowed (sec. 162(i)) for the year of failure and all subsequent years up to and including the year of correction. In addition, the exclusion from income under section 106 for employer-provided health coverage does not apply to the employer's highly compensated employees for such time.

Description of Proposal

The present-law sanctions for failures to satisfy the health care continuation rules would be replaced by an excise tax.

Amount of the excise tax

The amount of the excise tax for any failure to satisfy the health care continuation rules would be $100 per day during the noncompliance period with respect to such failure. This excise tax would apply separately with respect to each qualified beneficiary with respect to whom there has been a failure to satisfy the health care continuation rules.

Noncompliance period

In general.--The noncompliance period generally would begin on the date the failure first occurs and end on the date the failure is corrected. However, with respect to a qualified beneficiary, the noncompliance period would end, without regard to whether the failure has been corrected, on the date that is one year after the last date on which the employer could have been required to provide continuation coverage to such qualified beneficiary, determined without regard to whether the qualified beneficiary paid any required premium.

Inadvertent failures.--Subject to certain special rules described below, the noncompliance period would not start on the date the failure first occurred if it can be established to the satisfaction of the Secretary that none of the persons who could be liable for the tax knew, or exercising reasonable diligence would have known, that the failure existed. In such a case, the noncompliance period would not commence until any of such persons knew or should have known of the failure. For purposes of this rule (and the other rules described below), a person is deemed to know the law under which the particular fact situation constituted a failure.

30-day grace period

The excise tax generally would not apply to any failure if such failure was due to reasonable cause and not to willful neglect and such failure is corrected within the first 30 days of the noncompliance period with respect to such failure.

Audit rule

A special audit rule would override the inadvertent-failure and 30-day grace period rules described above. Under this special audit rule, if a failure with respect to a qualified beneficiary is not corrected by the date a notice of examination of income tax liability is sent and if the failure occurred or continued during the period under examination, the excise tax with respect to such qualified beneficiary would not be less than the lesser of (a) $2,500 or (b) the excise tax determined without regard to the inadvertent failure and 30-day grace period rules. To the extent that failures for any year are more than de minimis, $15,000 would be substituted for $2,500 in the preceding sentence.

One purpose of the special audit rule is to ensure that employers (and other persons liable for the tax, such as an insurance company or health maintenance organization (see discussion below)) have an incentive to monitor themselves for compliance with the health care continuation rules.

Maximum liability

Plans other than multiemployer plans

In the case of failures with respect to plans other than multiemployer plans, the maximum excise tax for failures during an employer's taxable year would be the lesser of (1) 10 percent of the total amount paid or incurred by the employer (or predecessor employer) during the preceding taxable year for the employer's group health plans, or (2) $500,000. If related employers that are treated as a single employer for purposes of the health care continuation rules have different taxable years, the taxable years taken into account would be determined based on the principles of Code section 1561. (Unlike sec. 1561, the maximum determined in the manner described above is not divided among the related employers, but rather applies as if all the related employers were a single employer.)

The limit described above would not apply to failures to satisfy the health care continuation rules that are attributable to willful neglect. Under rules prescribed by the Secretary, a failure that originally was not attributable to willful neglect would become attributable to willful neglect when a person liable for the tax does not make or ceases to make reasonable efforts to correct such failure at a time during the noncompliance period when it is correctable and the person knows of such failure.

<u>Multiemployer plans</u>

In the case of failures with respect to a multiemployer plan, the maximum excise tax for failures during the taxable year of the plan trust would be the lesser of (1) 10 percent of the total amount paid or incurred by the trust during the trust's taxable year to provide medical care (as defined in sec. 213(d)), or (2) $500,000. For purposes of this rule, all trusts forming part of a multiemployer plan would be treated as one trust and, if such trusts have different taxable years, a common 12-month period is to be designated as the trusts' taxable year. Also, as is the case with respect to plans other than multiemployer plans, the limit would not apply to failures that are attributable to willful neglect.

If an employer is liable for an excise tax attributable to a failure with respect to a multiemployer plan, such liability would be treated as if it related to a plan other than a multiemployer plan and thus would be subject to the limit described above.

<u>Correction</u>

A failure to satisfy the health care continuation rules would be considered corrected if--

(1) the rules are retroactively satisfied to the extent possible; and

(2) the qualified beneficiary (or his or her estate) is placed in a financial position that is as good as he or she would have been in had the failure not occurred.

For purposes of (2), it is to be assumed that the qualified beneficiary would have elected, at any time an election could have been available, to receive continuation coverage during the period of the failure that would have provided the maximum net benefit, i.e., the excess of benefits over premiums, in light of the qualified beneficiary's actual experience.

Liable persons

Plans other than multiemployer plans

In the case of a failure with respect to coverage provided by a plan other than a multiemployer plan, the employer would be liable for the excise tax. In addition, certain other persons would be jointly and severally liable with the employer. Such persons would include each person who is responsible (other than in a capacity as an employee) for administering or providing benefits under the plan and whose act or failure to act caused (in whole or in part) the failure. However, such a person would not be liable to the extent that an employer's act or failure to act made the person unable to comply with its responsibilities under the health care continuation rules. Examples of a person whose act or failure to act could cause a failure would include a health maintenance organization, an insurance company, and a plan administrator.

Under a special rule, a person would be considered to cause a failure if (1) such person fails to comply with a written request of the employer (or, in appropriate cases, a written request of a qualified beneficiary or plan administrator) to make available with respect to qualified beneficiaries the same services and benefits that such person provides with respect to similarly situated active employees, and (2) such services and benefits are not made available by any person with respect to such qualified beneficiaries. Generally, the purpose of this rule is to make liable any party, such as an insurance company, that contracts with the employer to provide health coverage to the employer's active employees but refuses to provide coverage for the employer's qualified beneficiaries.

It is understood that when an employer changes from one insurance company to another, State law often imposes similar requirements on the new insurance company to continue to provide coverage to the employer's existing insureds. As is the case generally with respect to the health care continuation rules, these State laws are not affected by the special rule described above. The special rule and the State laws are to apply concurrently so that in any specific instance, the more extensive requirements will apply. Thus, for example, if under State law the qualified beneficiaries are entitled in one respect to greater rights than under the health care continuation rules such that compliance with State law automatically means compliance with the health care continuation rules, the State law rule becomes the operative rule with respect to that aspect.

There would be a safe harbor under which a person would not be considered to have caused a failure in whole or in part. The safe harbor would apply if (1) the person has in effect a written agreement with the employer that accurately reflects the parties' agreement in practice, and (2) the failure relates solely to a responsibility allocated under the written agreement to an entity other than such person. This safe harbor would not apply to the special rule described in the second preceding paragraph.

Multiemployer plans

In the case of a failure with respect to coverage provided by a multiemployer plan, the rules regarding liability would be the same as the rules described above with two exceptions. First, "multiemployer plan" would replace "employer" each place the employer is referred to above. (Thus, an employer would only be liable if it caused the failure in whole or in part.) Second, it is clarified that the multiemployer plan document may constitute the written agreement referred to in the safe harbor rule.

Waiver

In the case of a failure that is due to reasonable cause and not to willful neglect, the Secretary would be authorized to waive part or all of the excise tax to the extent that the tax would be unreasonably burdensome. The determination of whether a tax is unreasonably burdensome is to be made based on the seriousness of the failure and not on a particular taxpayer's ability to pay the tax.

In determining whether to exercise this waiver authority, the Secretary would take into account the extent to which the person liable for the tax monitored itself for failure to satisfy the health care continuation rules.

Deductibility

The excise tax would be nondeductible.

Reasons for Change

The present-law sanctions for a failure to satisfy the health care continuation rules do not take into account the number of beneficiaries with respect to whom there is a failure, the period of time during a taxable year in which the failure occurred, an employer's knowledge of the failure, or whether the failure is corrected during the taxable year. These factors should be taken into account. Therefore, the present-law sanctions would be replaced by an excise tax that takes into account these factors.

Effective Date

This provision would apply to taxable years beginning after December 31, 1988. Of course, this provision would not apply to any plan with respect to a period for which the health care continuation rules are not effective under the original effective date of the rules.

In addition, it would be intended that, with respect to taxable years beginning before January 1, 1989, the Secretary would exercise administrative restraint in applying the sanction technically applicable under present law, taking into account whether the employer has made all reasonable efforts to prevent and correct any violation of the health care continuation rules.

2. Nondiscrimination rules for employee benefit plans

Present Law

In general

Under present law, new nondiscrimination rules apply to statutory employee benefit plans (sec. 89). The term "statutory employee benefit plans" includes accident or health plans and group-term life insurance plans. At the election of the employer, the term also includes qualified group legal services plans, educational assistance programs, and dependent care assistance programs.

Under the new nondiscrimination rules, a plan generally is required to satisfy 3 eligibility tests--a 50-percent test, a 90-percent/50-percent test, and a nondiscriminatory provision test--and a benefits test. Alternatively, a plan may satisfy an 80-percent coverage test, provided it also satisfies the nondiscriminatory provision test.

Nondiscrimination tests

50-percent test

Under the 50-percent test, nonhighly compensated employees must constitute at least 50 percent of the group of employees eligible to participate in the plan. This requirement will be deemed satisfied if the percentage of highly compensated employees who are eligible to participate is not greater than the percentage of nonhighly compensated employees who are eligible.

90-percent/50-percent test

A plan does not satisfy the 90-percent/50-percent test unless at least 90 percent of the employer's nonhighly compensated employees are eligible for a benefit that is at least 50 percent as valuable as the benefit available to the highly compensated employee to whom the most valuable benefit is available. For purposes of this test, all plans of the same type (i.e., all benefits excludable under the same Code section) are aggregated.

Nondiscriminatory provision test

The third eligibility test provides that a plan may not contain any provision relating to eligibility to participate that by its terms or otherwise discriminates in favor of highly compensated employees. This third test is intended to disqualify arrangements only on the basis of discrimination that is not quantifiable.

75-percent benefits test

A plan does not satisfy the benefits test unless the average employer-provided benefit received by nonhighly compensated employees under all plans of the employer of the same type (i.e., plans providing benefits excludable under the same Code section) is at least 75 percent of the average employer-provided benefit received by highly compensated employees under all plans of the employer of the same type.

Alternative 80-percent test

Present law also provides an alternative test that may be applied in lieu of the eligibility and benefits tests described above. If a plan benefits at least 80 percent of an employer's nonhighly compensated employees, such plan is considered to satisfy the new nondiscrimination rules. This alternative test will not apply unless the plan satisfies the nondiscriminatory provision test described above.

This alternative test applies only to accident or health plans and group-term life insurance plans. For purposes of this alternative test, an individual will only be considered to benefit under a plan if such individual receives coverage under the plan; eligibility to receive coverage is not considered benefiting under the plan.

Valuation

The Secretary is to prescribe rules regarding valuation of different benefits. With respect to health coverage, the Secretary is to establish tables prescribing the relative values of different types of health coverage.

Definitions

For purposes of applying the new nondiscrimination rules, present law provides generally applicable definitions of the following: (1) highly compensated employee (sec. 414(q))(see discussion below); (2) employer (including the employee leasing rules (sec. 414 (b), (c), (m), (n), (o), and (t))); (3) line of business or operating unit (as present law permits the new nondiscrimination rules to be applied separately to separate lines of business or operating units (sec. 414(r))); and (4) employees who are excluded from consideration. These definitions, other than the line of business or operating unit rule, apply generally to all employee benefit plans, not only to statutory employee benefit plans.

Definition of highly compensated employee

In general, an employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer; (2) received more than $75,000 in annual compensation from the employer; (3) received more than $50,000 in annual compensation from the employer and was a member of the top-paid group (generally the top 20-percent by compensation) of the employer during the same year; or (4) was an officer of the employer. However, an employee is not treated as in the top-paid group, as an officer, or as receiving more than $50,000 or $75,000 solely because of the employee's status during the current year unless such employee is also among the top 100 employees by compensation in such year.

The identity of the highly compensated employees is to be determined on an employer-wide basis, not on the basis of, for example, a line of business or operating unit.

A former employee is treated as a highly compensated employee of an employer if such employee was a highly compensated employee of the employer either when he or she separated from service or at any time after attaining age 55.

Qualification and reporting requirements

Employee benefit plans generally are subject to new qualification and reporting requirements (sec. 89(k) and (l)).

Effective date

In general, these rules are effective for years beginning after the later of--

(1) December 31, 1987, or

(2) the earlier of (a) the date that is 3 months after the date on which the Secretary issues regulations under section 89, or (b) December 31, 1988.

Description of Proposal

Phased-in implementation

The amendment would provide a group of interim and permanent rules that are intended to facilitate initial compliance with the section 89 rules.

Valuation

Under the introduced bill, any rules issued by the

Secretary with respect to the valuation of accident or health coverage are effective as of the later of (1) the first plan year beginning at least 6 months after issuance of such rules, or (2) the effective date specified by the Secretary for such rules. In addition, the bill provides a temporary special valuation rule for accident or health coverage that applies prior to the effective date of rules issued by the Secretary.

Under the amendment, the temporary special valuation rule would apply to all years beginning before January 1, 1991, without regard to whether the Secretary issues different valuation rules prior to such date.

Former employees

Under the amendment, employees who separated from service prior to January 1, 1987, generally may be disregarded in applying the nondiscrimination rules to former employees. However, if benefits are increased with respect to such employees after the effective date of section 89, such increases must be tested for discrimination. Thus, under the amendment, levels of benefits provided prior to the effective date of section 89 to the highly compensated employees among this group would in effect be grandfathered.

In addition, under the amendment, the Secretary is directed to issue rules facilitating the determination of which employees who separated from service prior to Janary 1, 1987, are highly compensated employees.

Testing dates

Under present law, the nondiscrimination rules generally apply based on benefits available and provided during the entire year. As discussed further below, the amendment generally would permit the nondiscrimination rules to be applied based on the benefits available and provided on one day in a year (with appropriate adjustments for plan design changes and certain employee elections). The testing date would be required to be designated in the plan and consistently applied. For years beginning in 1989, however, the consistency requirement would not apply, so that a plan could be tested on any date designated in the plan as the testing date for such year without affecting the employer's ability to modify the testing date in a subsequent year. This allows an employer, for example, to choose a testing date at the end of the first year beginning in 1989, while preserving the right to use the first day of the year in subsequent years.

Also as discussed below, the amendment would require that the sworn statements regarding family status and core health coverage from another employer generally relate to the facts in existence on the plan's testing date. This requirement would not apply to years beginning in 1989, providing additional flexibility with respect to compliance in such years.

Qualification requirements

Under the amendment, employers would be entitled to comply with the written plan requirement of section 89(k)(1)(A) for any plan year beginning in 1989 by completing the required, full written documentation by the end of such plan year so long as employees have reasonable notice of the plan's essential features on or before the beginning of such plan year and the provisions of the written plan are effective retroactively to the beginning of the plan year.

For years after 1989, rules prescribed by the Secretary are to permit employers a reasonable period to move from a written plan evidenced by a collection of separate written documents to a written plan evidenced by a stand-alone document.

Testing period

Under the amendment, an employer may designate in its plans a common 12-month period for testing all or some of its plans even if such plans have different plan years and even if none of the plans' plan years is the same as the common 12-month testing period. (The testing period chosen by the employer, whether it is this common 12-month period or each plan year, is referred to as the testing year.) This rule allows employers to avoid overlapping testing periods based on the use of different plan years for different plans.

Time for testing

Under present law, the nondiscrimination rules generally apply based on benefits available and provided during the entire year. Under the amendment, the rules generally would be required to be applied based on the benefits available and provided on one day in a year. However, adjustments would be required with respect to plans of the same type (i.e., plans providing benefits excludable under the same Code section) if during the year with respect to any such plan, there is a change in plan design or any election by a highly compensated employee to change his or her benefits in any way. Pursuant to these adjustments, such plan design changes and elections would be required to be taken into account as of the testing date, but would be pro-rated based on the period of time during which they were in effect during the year.

Under the amendment, an employer would be entitled to certain flexibility in choosing the date on which it measures the effect of a change in plan design on elections by nonhighly compensated employees.

The annual testing date is to be specified i the plan document. Such date is required to be the same for all plans of the same type (except that two groups of plans may have two different dates if the two groups are in different lines of business or operating units recognized under sec. 414(r)). Except to the extent provided above in the discussion of phased-in implementation, a plan's testing date may not be changed without the prior consent of the Secretary.

Sampling

Under the amendment, employers would be entitled to demonstrate compliance with section 89 on the basis of a statistically valid random sample of all employees that is not inconsistent with rules prescribed by the Secretary. Such random sampling may be performed only by an independent third party.

For this purpose, sampling will be treated as valid only if the statistical method and sample size produce a 99 percent level of confidence that the sample results have a margin of error not greater than 2 percent. Also, there may be a reasonable finite population correction in the minimum sample size where the number of employees to be sampled exceeds a specified level (e.g., the greater of (1) 20 percent of all employees or (2) 1,000 employees).

The sampling described above is only permissible for discrimination testing purposes. It is not permitted for purposes of identifying the highly compensated who have a discriminatory excess or the amount of such discriminatory excess.

Valuation

The amendment would modify the rules relating to the valuation of benefits in two respects that affect such valuation after the temporary special valuation rule described above no longer applies.

First, under the amendment, the Secretary would be directed, in prescribing the value of health benefits for the period after the temporary special valuation rule no longer applies, to take into account any managed care aspects of such benefits. For example, because of such managed care aspects, a health maintenance organization (HMO) may be able to provide greater health care coverage than an indemnity plan at the same cost to the employer. A valuation technique that focused only on plan coverages could thus overvalue the HMO. (This issue is implicitly addressed in the temporary special valuation rule because employers are permitted to use a plan's cost as its value.)

Second, both during and after the application of the temporary special valuation rule, in determining the benefits provided under a multiemployer plan, an employer generally may treat the contribution it makes to the plan on behalf of an employee as the benefit provided to the employee under such multiemployer plan. If the allocation of plan benefits between highly compensated employees and nonhighly compensated employees varies materially from the allocation of plan contributions, however, the employer is to adopt a general method of eliminating such material variation through an appropriate adjustment to plan contributions. If the plan contribution relates to benefits of different types (such as health benefits and group-term life insurance), a reasonable allocation is required.

This special rule for multiemployer plans would not apply to a multiemployer plan that covers any professional (e.g., a doctor, lawyer, or investment banker). No inference is intended from this provision that a plan covering a professional may be a multiemployer plan.

Definition of highly compensated employee

Under the amendment, employers would be entitled to elect to determine their highly compensated employees under a simplified method. The simplified method would be the same as present law with the following exception. The employer would not be required to determine the employees who (1) received more than $75,000 in annual compensation from the employer, or (2) received more than $50,000 in annual compensation from the employer and were members of the top-paid group. In lieu of these determinations, the employer would simply be required to determine the employees who received more than $50,000 in annual compensation from the employer.

An employer would not be entitled to make this election with respect to a current testing year unless (1) the employer did not maintain a top-heavy plan (sec. 416) at any time during such year, and (2) at all times during such year, the employer maintained business activities and employees in at least two geographically separate areas (within the meaning of sec. 414(r)(7)).

This modification of the definition of highly compensated employee would apply for all purposes for which the term applies (e.g., with respect to the discrimination rules applicable to qualified plans).

Part-time employees

Under present-law, under certain circumstances, employees who normally work less than 17-1/2 hours per week are disregarded in applying the nondiscrimination rules. There are also special rules for employees who normally work less than 30 hours per week.

The amendment provides a simplified method of determining the number of hours an employee is considered to work normally in a week. Under the amendment, until the end of the applicable testing year in which an employee commences work, an employee is considered to work normally the average number of hours such employee is scheduled to work during such year (disregarding any time the employee is not employed by the employer). The determination of the average scheduled hours is to be made in good faith and is to take into account periods in which it is expected that hours will be higher due to, for example, seasonal business cycles.

For subsequent testing years, an employee would be considered to work normally the average number of hours worked during the preceding testing year (disregarding any time the employee was not employed by the employer).

In determining the number of hours an employee has worked or is scheduled to work, rules similar to the qualified plan "hour of service" rules would apply.

<u>Initial service requirements</u>

Generally, under present law, for purposes of the nondiscrimination rules, employees who have not completed one year of service (or, in the case of core health benefits, six months of service) are disregarded. However, the one-year and six-month figures generally are reduced to the shortest initial service requirement applicable to any employee for eligibility in a plan of the same type (i.e., a plan providing benefits excludable under the same Code section) except that for this purpose core health plans are considered to be of a different type than other accident or health plans.

Under the amendment, the initial service requirement applicable under a multiemployer plan would not be taken into account in determining the extent to which the one-year and six-month figures are reduced. Thus, even if a multiemployer plan provides core health benefits to an employee on the first day such employee is employed by an employer, such fact would not in itself cause the six-month figure to be reduced to zero for such employer's core health plans.

This special rule for multiemployer plans would not apply to a multiemployer plan that covers any professional (e.g., a doctor, lawyer, or investment banker). No inference is intended from this provision that a plan covering a professional may be a multiemployer plan.

Comparability

For purposes of applying the 80-percent test to accident and health plans, in general, a group of plans are comparable and may be aggregated as one plan if the least valuable plan has a value of at least 95 percent of the value of the most valuable plan.

Under the amendment, an employer may elect to reduce the 95-percent figure to 80-percent and thus increase the range in value between plans that may be considered comparable. However, in any year that election is made, the 80-percent test is modified to be a 90-percent test; thus, if the election is made, a plan satisfies the nondiscrimination rules under section 89(f) if (1) it covers at least 90 percent of the employer's nonhighly compensated employees, and (2) it satisfies the nondiscriminatory provision test (sec. 89(d)(1)(C)). If made, this election generally applies to all accident and health plans maintained by the employer except that if the nondiscrimination rules are applied separately to separate lines of business or operating units, each such line of business or operating unit may make its own election.

Other coverage

Under present law, for purposes of applying the 75-percent benefits test to accident or health plans, an employer generally may disregard any employee or family member of an employee if such individual receives core health coverage from another employer of the employee or of the employee's spouse or dependents.

The amendment would expand this rule in two respects. First, under the amendment, an individual could be disregarded based on core health coverage received from another employer of any family member, including a parent. Second, with respect to testing accident or health coverage, the 80-percent test would be modified to have two parts: (1) the present-law 80-percent coverage requirement with the "other coverage" rule described above, and (2) a requirement that the plan be available to 80 percent of the employer's nonhighly compensated employees.

Sworn statements

Under present law, in order to use the other coverage rule described above or a special family coverage rule, an employer is required annually to obtain sworn statements on an IRS form to demonstrate whether individuals have core health coverage from another employer or, in the case of the family coverage rule, whether employees have a spouse or dependent. Present law permits employers to secure the sworn statements from a statistically valid sample of all employers.

The amendment would modify the sworn statement rule in several respects. First, under the amendment, the sworn statements would not be required to be on an IRS form; the IRS would be directed to supply language for inclusion on appropriate employer documents (such as enrollment forms). Second, after initial enrollment, the sworn statements (from all employees or only a sample) would be required to be collected no more frequently than once every three years except to the extent that an employee otherwise makes an election with respect to an employee benefit program (including an election not to participate). In addition, except to the extent provided above in the discussion of phased-in implementation, the triennial collection of sworn statements must relate to the facts in existence on the annual testing date. Sworn statements other than the triennial collections need only be taken into account with respect to testing dates following the collection of such statements.

The third modification would be that no nonhighly compensated employee (or family member) may be disregarded based on their receipt of other core health coverage unless the employer informs the employee that he or she has the right, if such other coverage ceases, to elect health coverage from the employer without regard to whether it is otherwise open season. For all purposes, such election is to be on the same terms as if such employee had initially elected health coverage from the employer and at a subsequent open season was changing such coverage.

A similar rule would apply in the case of the treatment of an employee as not having a family member. Thus, no nonhighly compensated employee may be treated as not having a family unless the employer informs the employee that he or she has the right, if the employee subsequently has a family, to elect health coverage for such family from the employer, without regard to whether it is otherwise open season. For such purposes, such election is to be on the same terms as if such employee had initially elected individual coverage or no coverage (as the case may be) and at a subsequent open season elected to cover his or her family.

The modifications described in the preceding two paragraphs would apply to years beginning after December 31, 1989.

Further, the amendment would modify a rule included in the introduced bill. Under the bill, an employer ("first employer") may treat an individual as having core health coverage from another employer without a sworn statement if (1) the first employer makes core health coverage available to the individual at no cost, and (2) such coverage and all other health coverage from the first employer are rejected. Under the amendment, the rule in (2) is modified to require only rejection of all core health coverage.

Line of business

Highly compensated employee percentages

Under present law, if an employer is treated as operating separate lines of business or operating units for a year, the employer generally may apply the section 89 nondiscrimination rules separately to each separate line of business or operating unit for that year. For this purpose, a bona fide line of business or operating unit is not treated as separate unless (1) it has at least 50 employees; (2) the employer notifies the Secretary with respect to the line or unit; and (3) either certain guidelines are satisfied or a determination is received from the Secretary. There is a safe-harbor method of satisfying the third requirement based on the proportion of highly compensated and nonhighly compensated employees in the line of business or operating unit (sec. 414(r)(3)).

The amendment would allow the safe-harbor rule to be applied based on the proportions in the preceding plan year if (1) no more than a de minimis number of employees shifted to or from the line of business or operating unit since the end of the prior year; or (2) the employees shifted to or from the line of business or operating unit since the end of the prior year contained a roughly proportional number of highly compensated employees.

Allocation of employees

Present law provides special rules for allocating employees who work for more than one line of business or operating unit to a particular line of business or operating unit. The first step in such allocation is to allocate to a line of business or operating unit any employee who performs a majority of his or her services for such line of business or operating unit.

Under the amendment, the first step described above would be modified so that only employees who perform at least 75 percent of their services for a particular line of business or operating unit would be required to be allocated to such line of business or operating unit pursuant to such first step.

Application for qualified plan purposes

The modifications described above with respect to separate lines of business or operating units would also apply for qualified plan purposes.

Definition of plan

Under present law, each different option generally would be a different plan. Under the amendment, each different option would be valued separately, but would not be considered a separate plan. A plan would be a group of options with comparable values (under the present-law comparability rules). Thus, the 50-percent test and the 80-percent test would apply to such plans, as redefined. (Because comparable options could be aggregated to constitute a plan, comparable plans could not be aggregated.)

For purposes of the other applicable tests, all plans are tested together (unless the separate testing of family coverage is elected).

With respect to the nondiscrimination rules, the effect of these changes would be only one of terminology rather than of substance. It is included in the amendment because so many employers have been confused by the use of the term "plan" to refer to each different option. (For convenience, the present-law terminology is used throughout this document; that avoids the further confusion that would result if the terms were used in different ways in different parts of this document.)

These changes are not intended to limit the authority of the Secretary either with respect to allowing flexible means of satisfying the plan qualification requirements of section 89(k) or with respect to establishing an appropriately tailored sanction for violations of section 89(k).

Penalty for failure to report

Under present law, except to the extent provided by the Secretary, if an employer does not report the discriminatory excess to the affected employees and the IRS by the due date (with an extension) for filing the required forms, the employer is liable for a tax at the highest individual rate on the total value of benefits of the same type provided to employees with respect to whom the employer failed to report the discriminatory excess. This tax does not apply if the employer can demonstrate the failure to report was due to reasonable cause.

Under the amendment, the penalty tax with respect to an employee would be the penalty tax determined under present law reduced by the amount of the discriminatory excess properly reported by the employer in a timely fashion.

The same rule would apply in the case of amounts includible by reason of a failure to satisfy the qualification rules.

Treasury rules

Under the amendment, the Secretary would be required to issue rules by October 1, 1988, providing guidance under section 89 on which employers may rely. Such guidance is to address those areas not addressed by the statute or legislative history and with respect to which employers need immediate guidance in order to comply with the nondiscrimination rules.

Good faith

As is the case with respect to any statute for which there is no guidance issued by the Secretary, taxpayers are expected to make reasonable interpretations of section 89 based on the statute and its legislative history. The amendment clarifies that until the issuance of rules by the Secretary an employer's compliance with its reasonable interpretation, if made in good faith, constitutes compliance with section 89.

Reasons for Change

The application of comprehensive nondiscrimination rules to employee benefit plans requires significant adjustments for employers that have never assembled and analyzed the data with respect to their employee benefit plans. For this reason, the Tax Reform Act of 1986 provided a delayed effective date and extensive legislative history with respect to how the rules would work. The detailed legislative history provided employers a means to prepare for the application of the rules.

As employers have prepared to apply the rules, they have identified and proposed modifications of the rules that would simplify their administration of the rules without undermining the objective of nondiscrimination. The amendment includes such proposed modifications.

In addition, the amendment provides certain interim rules designed to ease implementation of the nondiscrimination rules for the first year for which they apply. Given that Treasury rules have not yet been issued and that employers maintain that they need guidance in order to comply with the rules in 1989, the amendment provides significant guidance and maximum flexibility to employers in testing their plans for 1989.

Effective Date

Except as otherwise provided, these provisions would apply as if included in the Tax Reform Act of 1986.

C. Gift Tax Treatment of Joint and Survivor Annuities

Present Law

The Federal gift tax applies to gifts of property to the extent that the value of the gifts exceeds permitted deductions. A taxable gift occurs with respect to an annuity when the donor irrevocably designates a beneficiary.

A marital deduction is allowed for Federal estate and gift tax purposes for an interest in property passing to a spouse if that interest is not terminable, i.e., it does not terminate and pass to a person other than the spouse. The terminable interest requirement insures that the property generally will be subject to transfer tax with respect to one spouse.

Generally, to avoid receiving a terminable interest, a donee spouse must have use of the property during his or her life and control over who will receive the property on his or her death. A special rule applicable to qualified terminable interest property (QTIP) allows a marital deduction where the donee spouse only has an income interest in the property if an election is made to include the property in his or her estate and any Federal estate tax is paid out of the QTIP.

The transfer of an interest in a joint and survivor annuity for two spouses may not qualify for the marital deduction. Because the spouse's interest may terminate and pass to the donor, it may be a terminable interest. The transfer may not qualify for the QTIP rule because the donee spouse may not have an income interest in the annuity if he or she predeceases the donor.

Description of Proposal

The transfer to a spouse of an interest in a joint and survivor annuity in which no person other than the spouses has the right to receive any payments prior to the death of the last spouse to die would, unless otherwise elected, qualify for a marital deduction for Federal estate and gift tax purposes under the QTIP rule. If the donee predeceases the donor, no amount with respect to the annuity would be includible in the donee's estate.

Reasons for Change

The general intent in allowing a QTIP to qualify for the marital deduction was to exempt transfers between spouses from estate and gift tax so long as the property is includible in the surviving spouse's estate. Many joint and survivor annuities have been created since the enactment of the Retirement Equity Act, which generally required a joint and survivor annuity as an automatic form of benefit under a qualified pension plan and it is believed that QTIP treatment is appropriate for the creation of such annuities.

Effective Date

The provision would be effective for decedents dying, and transfers made, after December 31, 1981. Returns filed prior to the date of enactment of this provision would be unaffected unless otherwise elected within two years after the date of enactment of this provision. The time for election out would not expire prior to two years after the date of enactment of this provision.

D. Eligible Deferred Compensation Plans (Sec. 457 Plans)

Present Law

Under present law, unfunded deferred compensation that is provided by a State or local government or by a nongovernmental tax-exempt organization is subject to certain special rules (sec. 457). Under these special rules, the treatment of unfunded deferred compensation depends on whether the deferred compensation is provided under an eligible deferred compensation plan. To qualify as an eligible deferred compensation plan, a plan is required to satisfy certain requirements with respect to, for example, the maximum amount of deferrals that may be made by any participant in any year.

Unfunded deferred compensation provided under an eligible deferred compensation plan is includible in the income of the individual performing services (or his or her beneficiary) in the year in which it is paid or made available. On the other hand, with respect to any State or local government or nongovernmental tax-exempt organization, any unfunded deferred compensation not provided under an eligible deferred compensation plan is includible in income when and to the extent that it is not subject to a substantial risk of forfeiture.

Description of Proposal

Under the amendment, section 457 would not apply in three circumstances. First, the position of the IRS in Notice 88-68 would be codified and section 457 would not apply to bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans. Second, with respect to nonelective deferred compensation provided under a plan maintained pursuant to a collective bargaining agreement in effect on the date of enactment, section 457 would not apply until the expiration of such agreement. This second rule would not apply, however, unless the same plan for the same class of individuals had been maintained pursuant to a collective bargaining agreement in effect on January 25, 1987.

Third, section 457 would not apply to nonelective deferred compensation provided to individuals other than in their capacities as employees.

For purposes of these rules, a deferred compensation plan would be considered nonelective only if all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship to the payor are covered under the same plan with no individual variations or options within the plan. For example, if a nonemployee doctor receives deferred compensation from a hospital, such deferred compensation is to be considered nonelective only if all nonemployee doctors (who have satisfied any applicable initial service requirement) are covered under the same plan.

Reasons for Change

The provision relating to vacation leave plans, etc., codifies a position taken in IRS Notice 88-68, which represents Congress' original intent with respect to section 457.

The exemption for nonelective deferred compensation plans for nonemployees is appropriate because such plans do not affect the incentives to maintain qualified plans (which may only be maintained for employees) and do not permit manipulation of tax liability.

The exemption for collectively bargained plans recognizes that prior to January 26, 1987, many taxpayers were not aware of the IRS position (as published that day in IRS Notice 87-13) that nonelective deferred compensation is subject to section 457. Therefore, collectively bargained agreements were entered into based on the assumption that section 457 did not apply to nonelective deferred compensation.

Effective Date

The provision would apply to taxable years beginning after December 31, 1987.

PART FOUR: EXTENSIONS

1. Extension of exclusion for employer-provided educational assistance

Present Law

Under present law, an individual may (subject to the two-percent floor on nonreimbursed employee expenses) deduct from income amounts expended for education if the education is job-related (sec. 162). Education is job-related if it (1) maintains or improves skills required for the employee's job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of continued employment in the same job. Job-related education expenses that are reimbursed by an individual's employer are excludable from gross income. Educational assistance provided by the employer that is not job-related is includible in income.

Under prior law (taxable years beginning before January 1, 1988), an employee's gross income for income and employment tax purposes did not include amounts paid or incurred by the employer for educational assistance provided to the employee (without regard to whether the education was job-related) if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements (sec. 127). This exclusion, which expired for taxable years beginning after December 31, 1987, was limited to $5,250 of educational assistance with respect to an individual during a calendar year and did not apply to education involving sports, games, or hobbies. (References below to the exclusion for educational assistance are to this exclusion under sec. 127.)

In 1984, Congress required that employers file information returns with respect to educational assistance programs under section 127 (sec. 6039D). The purpose of this requirement was to collect data with respect to the use of such programs to provide Congress with a means to evaluate the effectiveness of the exclusion.

Description of Proposal

The exclusion for educational assistance would be restored retroactively to the date of expiration and would be extended so that it would expire for taxable years beginning after December 31, 1990. However, the exclusion would not apply to education leading to a postgraduate degree (other than for graduate teaching or research assistants). Moreover, the definition of education ineligible for the exclusion--i.e., education involving sports, games, or hobbies--would be clarified. Under this clarification, education with respect to a subject commonly considered a sport, game, or hobby, such as photography or gardening, would be ineligible for the exclusion unless such education (1) had a reasonable relationship to an activity maintained by the employee for profit; (2) had a reasonable relationship to the business of the employer; or (3) was required as part of a degree program (other than a postgraduate program).

Reasons for Change

The exclusion for educational assistance would be extended for three years to allow time for data on the exclusion to be collected under section 6039D (enacted in 1984) and evaluated.

The exclusion for educational assistance was intended to assist low- and middle-income employees in obtaining education that improved their skills and qualified them for better jobs. The exclusion for postgraduate education or education with respect to hobbies does not materially further this purpose.

Effective Date

The provision generally would be effective upon date of enactment. The amendment with respect to postgraduate education would apply to years beginning after December 31, 1988. The amendment with respect to hobbies is considered a retroactive clarification of prior law.

2. Extension of low-income rental housing tax credit

Present Law

A tax credit may be claimed by owners of newly constructed, rehabilitated, and newly acquired existing residential rental property used for low-income housing. The credit is claimed annually, generally for a period of ten years. Credit percentages are adjusted monthly for buildings placed in service in that month to maintain a present value of the credit stream of 70 percent of qualified expenditures for most newly constructed and rehabilitated housing. A 30-per cent present value is allowed in the case of acquisition of existing housing and of newly constructed or rehabilitated housing receiving other Federal subsidies, including tax-exempt bond financing.

To qualify for the credit, a low-income rental housing project must continuously comply with the requirements of the credit for a period of fifteen years after it is placed in service. The principal requirement is that a minimum percentage of housing units be continuously set-aside for use by individuals having incomes below prescribed levels. The minimum percentage is 40 percent for tenants having incomes of 60 percent or less of area median, or 20 percent for tenants having incomes of 50 percent or less of area median. A lapse in compliance with this or other Code requirements generally will result in the denial of the credit prospectively as well as a recapture of a portion of the tax benefits previously allowed, including an interest component to account for the time value of money.

The annual credit authority limitation for each State is equal to $1.25 for each individual who is a resident of the State. Ten percent of each State's credit authority is set aside for exclusive use for projects in which qualified nonprofit organizations participate. Credit authority lapses after December 31, 1989.

Description of Proposal

The present-law low-income rental housing credit would be extended for one year, through December 31, 1990. A conforming amendment would defer for one year the present-law provision permitting a limited carryover of the credit cap from the last year of the program into the following year.

Reasons for Change

The period since its inception shows a pattern of increased utilization of the low-income rental housing credit. An extension of the tax credit at this time will help to ensure continuity of usage of this housing subsidy, and will afford the committee an opportunity to gather more information on its operation and relative efficiency before deciding to continue, modify, or eliminate the program.

Effective Date

The provision would be effective on enactment.

3. Extension and modification of qualified mortgage bond and mortgage credit certificate programs

Present Law

Qualified mortgage bonds are tax-exempt bonds the proceeds of which are used to make mortgage loans to first-time homebuyers. As an alternative to qualified mortgage bonds, States and local governments may elect to trade in bond authority and issue mortgage credit certificates (MCCs). MCCs may be issued to the same persons who qualify for qualified mortgage bond financing. Authority to issue qualified mortgage bonds and to trade in bond authority to issue MCCs expires after December 31, 1988.

Beneficiaries of these programs are subject to two principal limits. First, the purchase price of homes for which the special assistance is received may not exceed 90 percent (110 percent in economically distressed areas) of the average purchase price of homes in the area where the assisted homes are located. Second, income of the mortgagor may not exceed 115 percent of the higher of area or State median income in nontargeted areas. In targeted economically distressed areas, the income limit is 140 percent of the higher of area or State median income for 2/3 of the financing provided. Income limits do not apply to 1/3 of the financing provided in these areas.

Subject to several exceptions, issuers of qualified mortgage bonds must satisfy the arbitrage restrictions that apply to all tax-exempt bonds. One of the exceptions permits issuers of these bonds, unlike issuers of governmental bonds, to retain arbitrage profits earned in temporary periods and use those profits for the benefit of assisted homebuyers.

Description of Proposal

Authority to issue qualified mortgage bonds and to trade in bond authority to issue MCCs would be extended for two years, through December 31, 1990.

Several modifications would be made to the rules governing these programs:

(1) The purchase price limit for assisted homes would be reduced to 75 percent of the average area purchase price (95 percent in targeted economically distressed areas).

(2) Income limits would be adjusted for family size as is done currently for multifamily rental housing bonds and for the low-income rental housing tax credit.

(3) Income limits would be determined by reference to area median incomes, and special adjustments would be

provided (subject to a maximum limit of 140 percent and a minimum limit of 90 percent) for nontargeted areas having significantly higher or lower than national ratios of area median incomes to area purchase prices (so-called "high cost" or "low cost" areas).

(4) Issuers of qualified mortgage bonds and qualified veterans' mortgage bonds would be required to rebate arbitrage profits to the Federal Government under the rules that now apply to issuers of governmental and other private activity bonds.

(5) A three-year loan origination period would be imposed for qualified mortgage bonds. Unspent proceeds and prepayments (received during the three-year period) would be required to be used to redeem bonds no later than six months after expiration of the origination period. Prepayments received thereafter would be required to be used to redeem bonds no later than the close of the semi-annual period following their receipt.

(6) An amount equal to the special subsidy provided by qualified mortgage bond-financing or an MCC (but not in excess of 50 percent of gain) would be recaptured on disposition of the house. Full recapture of this special subsidy would occur if the house were sold within 5 years; recapture would phaseout ratably in years 6 through 10. A special rule would exclude from recapture part or all of the special subsidy in the case of assisted individuals whose incomes were less than prescribed amounts at the time of the disposition. The recapture provision would not apply in the case of home improvement loans.

Reasons for Change

With the curtailment of many Federal direct expenditure programs providing housing assistance, it is important to conduct a complete review of the nation's housing needs, including the role of qualified mortgage bonds and MCCs in meeting these needs, before deciding to eliminate these programs. While it may be desirable to delay a decision to eliminate the programs, a number of modifications designed to target the benefits of the programs more accurately to persons needing assistance are appropriate at this time.

In a recent report, the General Accounting Office found that the average purchase price for all first-time-home buyers is 73 percent of average home purchase price. The proposal would create more targeted programs by reflecting this experience of first-time homebuyers.

The same report found that the present structure of the qualified mortgage bond and MCC income limit makes it easier for a single-person household to qualify for the programs than a family. Only 44 percent of assisted households were comprised of more than two persons. The proposal would target more benefits to families by adopting a family size adjustment generally applied in other Federal housing programs programs.

The GAO also found that in some areas of the country, housing prices are so high that a family with the maximum allowable income may have difficulty benefiting under the programs. In other areas of the country, housing prices were sufficiently low relative to income that families with the maximum allowable income could easily afford homes with conventional financing. The proposal would make the income limit more sensitive to these differing economic circumstances.

It is inappropriate to permit more liberal arbitrage rules for private activity bonds issued by quasi-private agencies than are permitted to State and local governments issuing governmental bonds. The proposal would extend the arbitrage rebate rules applicable to governmental bonds to all mortgage revenue bonds.

Requiring redemption of bonds with unspent proceeds and prepayments would reduce unnecessary revenue loss from the qualified mortgage bond program by limiting the amount of bonds that remain outstanding for long periods of time to that actually needed to finance mortgage loans and also would discourage earlier and larger issuance of bonds than otherwise required.

GAO found that the bond- and MCC-assisted population generally is younger and more likely to be single than the first-time homebuyer population generally. These buyers may be expected to "buy-up" as their marital status and incomes change. Additionally, a house provides a family with both consumption and investment benefits. Partial recapture of gain on disposition of bond- and MCC-assisted houses would target the special subsidy provided by the assistance to the consumption benefits. Further, GAO recommended a recapture provision to address use of the program by upwardly mobile buyers not requiring assistance. The proposal would adopt such a provision to target these programs more to people needing longer-term housing assistance.

<u>Effective Dates</u>

The provisions generally would be effective for bonds (including refunding bonds) issued and bond authority traded-in for authority to issue MCCs after December 31, 1988. The recapture proposal would apply to bond-financed loans originated and MCCs issued after December 31, 1988.

4. Research and development provisions

a. Extension of R&D credit

Present Law

A 20-percent tax credit is allowed for qualified research expenditures incurred by a taxpayer in carrying on a trade or business (Code sec. 41). Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years).

The credit is scheduled to expire after December 31, 1988.

Description of Proposal

The present-law research credit would be extended for two years (i.e., for qualified research expenditures through December 31, 1990).

Reasons for Change

The Tax Reform Act of 1986 extended the research credit for three years (through 1988) to obtain more complete and comprehensive information for purposes of evaluating whether the credit should be extended further or modified. For the same reason, an additional two-year extension is desirable.

Effective Date

Under the provision, the research credit will not apply to amounts paid or incurred after December 31, 1990.

b. Reduce section 174 R&D expense deduction by amount of section 41 research credit

Present Law

As a general rule, business expenditures to develop or create an asset that has a useful life that extends beyond the taxable year, such as expenditures to develop a new product or improve a production process, must be capitalized. However, Code section 174 permits a taxpayer to deduct currently (or to amortize over certain periods) the amount of research or experimental expenditures incurred in connection with the taxpayer's trade or business.

In addition, Code section 41 provides a 20-percent income tax credit for qualified research expenditures incurred by the taxpayer in carrying on its trade or business, to the extent current-year expenditures exceed the average of the taxpayer's yearly expenditures in the specified base period (generally, the three preceding taxable years). The credit is scheduled to expire after December 31, 1988.

Under present law, the amount of the taxpayer's section 174 deduction for research expenditures is not reduced by the amount of any section 41 credit also allowed to the taxpayer for incremental research expenditures.

Description of Proposal

The taxpayer's expensing or amortization deduction under section 174 for a taxable year would be reduced by the amount of the taxpayer's section 41 credit for that year.

For example, assume that a taxpayer makes credit-eligible research expenditures of $1 million during the year, and that the base period amount is $600,000. The taxpayer is allowed a tax credit equal to 20 percent of the $400,000 increase in research expenditures, or $80,000. Under present law, the taxpayer also may deduct the full $1 million research expenditure amount under section 174. Under the proposal, the taxpayer's deduction would be reduced by the $80,000 credit, leaving a deduction of $920,000.

Reasons for Change

The allowance of the credit, which reduces the taxpayer's Federal income tax liability by an amount equal to the specified percentage of incremental research expenditures, is equivalent to a Federal payment to a taxpayer of the credit amount. Accordingly, since the taxpayer in effect does not pay for its research expenditures to the extent of the credit, the taxpayer's deduction should be reduced by that amount.

For similar reasons, present law provides that the basis of depreciable property must be reduced by the full amount of the investment tax credit in the case of transition property, and by the full amount of the rehabilitation credit; under prior law, the basis of investment credit property generally was reduced by one-half of the credit amount. Likewise, present law provides that a taxpayer's section 174 or 162 deductions are reduced by the amount of the "orphan drug" clinical testing credit for such expenditures, and that an employer's deduction for wages paid to employees is reduced by the amount of the employer's targeted jobs tax credit for the year.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1988.

c. Allocation and apportionment of R&D expenses

Present Law

Treasury regulations promulgated in 1977 prescribe a detailed method for allocating R&D expenses. For purposes of allocating R&D expenses between U.S. and foreign source income, statutes effective for taxable years beginning after August 13, 1981, and on or before August 1, 1986 suspend the regulation with respect to expenses for R&D conducted in the United States (U.S. R&D expenses), providing instead that all such expenses are to be allocated to U.S. income.

Effective for taxable years beginning after August 1, 1986 and on or before August 1, 1987, U.S. R&D expenses incurred by U.S. persons are subject to statutory allocation rules of the 1986 Act. Under that Act, U.S. R&D expenses incurred to meet certain legal requirements may be allocated entirely to one geographic source; 50 percent of the remaining U.S. R&D expenses (after applying the legal requirements rule) are allocated to U.S. source income; and U.S. R&D expenses not allocated under the foregoing rules are allocated either on the basis of sales or gross income.

For taxable years beginning after August 1, 1987, all R&D expenses, including U.S. R&D expenses, are allocated under the 1977 Treasury regulations.

Description of Proposal

U.S. persons would allocate 67 percent of U.S. R&D expenses (other than any such amounts allocated to one geographical source because of legal requirements) to U.S. source income. Similarly, U.S. persons would allocate 67 percent of expenses for R&D conducted outside the United States (other than any such amounts allocated to one geographical source because of legal requirements) to foreign source income. The remainder of U.S. and foreign R&D expenses would be allocated on the basis of gross sales or (subject to a limit) gross income. The amount of R&D expense allocated to foreign source income on the basis of gross income would in all cases be at least half of the amount allocated to foreign source income on the basis of gross sales.

Expenses for R&D conducted in space, on or beneath the ocean outside the territorial waters of the United States or foreign countries, or on Antarctica, would be treated for these purposes as U.S. R&D expenses if incurred by U.S. persons and as foreign R&D expenses if incurred by persons other than U.S. persons.

Reasons for Change

The proposal will encourage U.S. research and development.

Effective Date

The provision generally would be effective for taxable years beginning after August 1, 1987 and before January 1, 1991. The aspect of the provision concerning the allocation of foreign R&D expenses would be effective for taxable years beginning after June 21, 1988 and before January 1, 1991.

5. Extension of targeted jobs tax credit

Present Law

Tax credit provisions

The targeted jobs tax credit is available on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 24; (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged former convicts; (7) economically disadvantaged former convicts; (8) Aid to Families with Dependent Children (AFDC) recipients and Work Incentive (WIN) registrants; and (9) economically disadvantaged summer youth employees aged 16 or 17. Targeted group membership must be certified.

The credit generally is equal to 40 percent of the first $6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is $2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 85 percent of up to $3,000 of wages, for a maximum credit of $2,550.

The credit is not available for wages paid to a targeted group member unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Also, the employer's deduction for wages must be reduced by the amount of the credit.

The credit is available with respect to targeted-group individuals who begin work for the employer before January 1, 1989.

Authorization of appropriations

Present law also authorizes appropriations for administrative and publicity expenses relating to the credit through September 30, 1988. These monies are to be used by the Internal Revenue Service (IRS) and Department of Labor to inform employers of the credit program.

Description of Proposal

The credit and the authorization for appropriations would be extended for two years. The category of economically disadvantaged youth would be restricted to employees aged 18 through 21.

Reasons for Change

Because evidence regarding the relative efficiency of the targeted jobs tax credit as an incentive for hiring disadvantaged individuals remains incomplete, an extension of the credit would provide the Congress and the Treasury Department a further opportunity to gather more information and better access its effectiveness as a hiring incentive.

Because youths 18 to 21 have an unemployment rate significantly higher than those in the 22 to 24 age group, the targeted jobs tax credit could be more effectively utilized by restricting the category of economically disadvantaged youth to those under the age of 22. This may provide an incentive for employers to direct the benefits of this program to those individuals most in need.

Effective Date

The provision would apply with respect to targeted-group individuals who begin work for the employer after December 31, 1988 and before January 1, 1991. Under the proposal, the credit would not apply with respect to individuals who begin work for the employer after December 31, 1990.

The authorization for appropriations would be effective for the period October 1, 1988 through September 30, 1990.

6. Treatment of mutual fund shareholder expenses with respect to the 2-percent floor on miscellaneous itemized deductions

Present Law

For taxable years beginning after December 31, 1986, miscellaneous employee and investment expenses are generally deductible by itemizers only to the extent that they exceed 2 percent of the taxpayer's adjusted gross income. As enacted in the Tax Reform Act of 1986, this 2-percent floor applies with respect to indirect deductions through regulated investment companies (mutual funds), i.e., certain investment expenses of such funds that would otherwise reduce shareholder taxable income are treated as miscellaneous deductions of individuals subject to the 2-percent floor.

The Omnibus Budget Reconciliation Act of 1987 (OBRA) delays treatment of shareholder expenses of publicly offered mutual funds as miscellaneous itemized deductions until taxable years beginning after December 31, 1987.

Description of Proposal

Shareholder expenses of publicly offered mutual funds would not be treated as miscellaneous itemized deductions (subject to the 2-percent floor).

Reasons for Change

The proposed change eliminates the administrative difficulties and confusion arising from applying the 2-percent floor to shareholder expenses.

Effective Date

The provision would be effective on the date of enactment.

7. Diesel fuel excise tax collection and exemption procedures

Present Law

The 15.1-cents-per-gallon excise tax on diesel fuel is imposed on the sale of the taxable fuel by a producer, defined to include a wholesale distributor as well as an actual producer of the fuel.

Exemptions from the 15-cents-per-gallon Highway Trust Fund rate are provided for off-highway business uses, including *inter alia*, use on a farm for farming purposes, use as supplies for vessels and trains, and use in construction activities. Further exemptions are provided for use by States and local governments and by nonprofit educational organizations.

In general, exemptions from the tax are realized by means of refunds (or credits against other tax payments) following tax-paid sales. The Treasury Department is authorized to adopt regulations permitting sales (on a case-by-case basis) without payment of tax when diesel fuel is sold directly by a producer to (1) a person who will use the fuel in a train or as a chemical feedstock and (2) States and local governments for their exclusive use. Fuel destined for use as heating oil also may be sold without payment of tax.

Pursuant to the Omnibus Budget Reconciliation Act of 1987, these provisions were effective on April 1, 1988.

Description of Proposal

The ability to purchase diesel fuel direct from producers without payment of the Highway Trust Fund tax would be extended to other off-highway business users (e.g., farmers) who were permitted to make such purchases before April 1, 1988. Additionally, the definition of producer would be modified to include retail dealers that exclusively sell diesel fuel to waterway and marine users.

All persons purchasing diesel fuel without payment of tax would be required to satisfy Treasury Department registration and bonding requirements, and expanded information reporting requirements similar to the Form 1099 requirements that apply to interest income would be imposed on sellers and exempt purchasers.

Reasons for Change

The proposal would alleviate potential cash-flow burdens imposed on off-highway business users who currently must advance funds equal to the 15.1-cents-per-gallon tax to the

Federal Government when they purchase diesel fuel and wait a period of time to receive a refund when no tax ultimately is due.

To curb the potential for tax evasion arising from expanding the number of persons qualifying to purchase fuel without payment of tax, expanded information reporting requirements would be adopted and Treasury's current authority to require registration and bonding of exempt purchasers would be extended.

Effective Date

The provision would apply to diesel fuel and nongasoline aviation fuel sold after July 1, 1988.

A special interest-bearing refund would be provided for persons allowed to purchase fuel without payment of tax under the proposal (but not allowed to do so under present law) for tax paid after March 31, 1988, and before July 1, 1988.

PART FIVE: REVENUE RAISERS

1. Reduction in dividends received deduction for portfolio stock

Present Law

Under present law, corporations owning less than the portfolio threshold of 20 percent of the stock of a corporation (by vote and value) are entitled to a deduction equal to 70 percent of the dividends received from a domestic corporation. Corporations owning at least 20 percent are entitled to an 80-percent deduction and corporations owning 80 percent or more may be entitled to a 100 percent deduction.

For purposes of determining whether the 80 percent threshold is met, the ownership of certain corporations under common control may be aggregated.

Description of Proposal

The dividends received deduction for a corporation owning less than the portfolio threshold amount of the stock of a distributing corporation would be reduced from 70 percent to 55 percent. The threshold requirement would be ownership of more than 20 percent of the stock of a corporation (by vote and value).

For purposes of determining whether the more than 20 percent threshhold is met, the ownership of corporations could be aggregated to the same extent that it is aggregated under present law for purposes of the 80 percent threshold.

Reasons for Change

The present-law dividends received deduction is too generous for corporations that are not eligible to be treated as the alter ego of the distributing corporation because they do not have a sufficient ownership interest in that corporation. It also permits an investor in a corporation to be treated as a greater than portfolio investor even though the Code may treat the corporation as the alter ego of other corporate investors for other purposes, such as consolidation.

Aggregation should be permitted for purposes of the portfolio stock dividends received deduction threshold to the same extent that it is permitted for purposes of the 80 percent threshold.

Effective Date

The change in the portfolio dividends received deduction would be phased in with a 60-percent deduction for dividends received or accrued after December 31, 1988, and a 55-percent deduction for dividends received or accrued after December 31, 1989. The change in the threshold for the portfolio dividends received deduction would apply to dividends received or accrued after December 31, 1988.

The change in the aggregation rules for purposes of determining whether the portfolio dividends received deduction has been exceeded would apply for dividends received or accrued after December 31, 1987.

2. Repeal of the completed contract method of accounting for long-term contracts

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. Under the percentage of completion method, income is reported based on the percentage of a contract completed during the year. Under the percentage of completion-capitalized cost method, 70 percent of a contract is reported according to the percentage of completion method, and 30 percent according to the completed contract method, under which income is reported in the year the contract is completed.

Certain small businesses may use the completed contract method fully with respect to contracts to be completed within two years.

Description of Proposal

The percentage of completion-capitalized cost method of accounting for long-term contracts would be repealed. Thus, the full amount of all long-term contracts (other than contracts of small businesses exempted under present law) would be reported on the (100 percent) percentage of completion method.

Reasons for Change

The completed contract method of accounting for long-term contracts does not accurately measure the income of the taxpayer since the income from the contract is earned throughout the life of the contract--not when the contract is completed.

On the other hand, the percentage of completion method recognizes income throughout the life of the contract as the income from the contract, as measured by the ratio of contract costs incurred by the taxpayer that year compared to total estimated costs, is earned. If the estimated costs are incorrectly estimated by the taxpayer so that the taxpayer paid the incorrect amount of taxes based upon actual costs incurred, the taxpayer would be paid interest in the case of an overpayment, or the taxpayer would pay interest in the case of an underpayment.

Effective Date

The proposal would be effective for contracts entered into on or after June 21, 1988.

3. Treatment of single premium and investment-oriented life insurance

Present Law

Under present law, the undistributed investment income ("inside buildup") earned on premiums credited under a life insurance contract generally is not subject to current taxation to the owner of the contract.

Distribution rules.--Amounts distributed from life insurance contracts (e.g., in a partial surrender of the contract) are treated first as a nontaxable recovery of basis and then as income to the recipient. Loans under life insurance contracts are generally not treated as distributions.

Under a deferred annuity contract, distributions prior to the annuity starting date are treated as income first and then as a nontaxable recovery of basis. Loans under deferred annuity contracts are treated as distributions.

Distributions from deferred annuity contracts generally are subject to a 10-percent additional income tax. This additional income tax does not apply in the case of distributions after the owner of the contract reaches age 59-1/2, dies, becomes disabled, or after the contract is annuitized. The additional income tax does not apply to distributions from life insurance contracts.

Basis rules.--Under present law, a policyholder's investment in a life insurance contract for purposes of determining gain on the contract generally is determined without adjustment for the cost of current term insurance protection. In determining the amount of any loss from the complete surrender of a life insurance contract, courts have held that the cost of insurance protection is not included in basis.[1]

Mortality and expense charges.--The favorable tax treatment accorded the owner of a life insurance contract is available only for contracts that satisfy a statutory definition of life insurance. Under this statutory definition, a contract must satisfy either a cash value accumulation test or a test consisting of a guideline premium requirement and a cash value corridor test. In determining whether a contract satisfies the cash value accumulation test or the guideline premium requirement, the mortality charges taken into account are the charges specified in the contract,

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[1] London Shoe Co., Inc., 80 F.2d 230 (2nd Cir. 1935); Century Wood Preserving Co., 69 F.2d 967 (3rd Cir. 1934).

or, if none are specified, the mortality charges used in determining the statutory reserve for the contract. In determining whether a contract satisfies the guideline premium requirement, the expense charges taken into account are the charges specified in the contract.

Description of Proposal

a. Rules relating to single premium and investment-oriented life insurance

Affected contracts.--Life insurance contracts not satisfying a 20-pay model would be subject to (1) revised distribution rules similar to the present-law rules for deferred annuities, and (2) basis adjustment rules.

Distribution rules.--Under the proposal, pre-death distributions from life insurance contracts not satisfying a 20-pay model would be treated as income first, loans would be treated as distributions, and an additional 15-percent income tax would be imposed on the portion of any distribution or loan that is includible in income. An exception to the 15-percent additional tax similar to the present-law rules for deferred annuities would be provided if the distribution occurs (1) on account of the taxpayer's disability, (2) upon a total surrender of the contract, as part of a series of substantially equal periodic payments over the taxpayer's life expectancy, (3) after the taxpayer's death, or (4) after the later of the date the taxpayer reaches age 59-1/2 or 20 years from the date the contract was issued.

Basis rules.--Under the proposal, in determining gain or loss with respect to a distribution from a life insurance contract not satisfying a 20-pay model, the policyholder's basis in the contract would be reduced by the term cost of insurance (i.e., the mortality charges) provided under the contract.

b. Conforming changes to rules for deferred annuities

The additional income tax on early distributions from deferred annuity contracts would be conformed to the rule for life insurance contracts not satisfying a 20-pay model. Thus, the rate of the additional tax would be 15 percent and an exception to the tax would be provided for distributions after the later of the date the taxpayer reaches age 59-1/2 or 20 years from the date the annuity contract was issued.

c. Mortality and expense charges taken into account

For all life insurance contracts, the mortality charges taken into account for purposes of the definition of life insurance would be required to be reasonable as determined under Treasury regulations and could not exceed the mortality charges required to be used in determining the Federal income tax reserve for the contract. The expense charges taken into account for purposes of the guideline premium requirement would be required to be reasonable based on the experience of the company and other insurance companies with respect to similar life insurance contracts.

d. Study

The Treasury Department and the General Accounting Office (GAO) would be directed to conduct studies of the effectiveness of the revised tax treatment of life insurance and annuity products in preventing the sale of life insurance primarily for investment purposes. The studies would be required to be submitted to the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation by July 1, 1990.

Reasons for Change

The widespread marketing of single premium life insurance contracts and other investment-oriented insurance products has raised concerns that the favorable tax treatment accorded life insurance products is not targeted primarily to the provision of death benefits. Rather, certain types of products are being marketed as tax-favored investments, taking advantage of the deferral of income that is normally reserved for retirement vehicles and products designed to furnish death benefits.

Single premium life insurance contracts are currently being marketed in a manner intended to attract purely investment-oriented investors into the life insurance market. Such marketing results in the purchase of life insurance products for noninsurance purposes and defeats the reason that favorable tax treatment was originally accorded to life insurance.

The proposals reduce the Federal tax subsidy for the purchase of life insurance contracts that are not held until death. Consequently, the proposals discourage the use of inside buildup for noninsurance purposes by defining a class of policies that are not eligible for favorable tax treatment in the case of a distribution or loan.

Because of concern that tax-deferred investment products would continue to be sold in the form of deferred annuity contracts if no conforming changes were made in that area, the rate of the additional income tax on early distributions is raised to 15 percent and the age 59-1/2 exception is modified to conform to the proposed rules for life insurance contracts not satisfying a 20-pay model.

With respect to the determination of a policyholder's basis in a life insurance contract, present law is inconsistent in its treatment of the calculation of loss on surrender of a contract on the one hand, and gain or income from surrender of the contract on the other hand. The determination of gain should be conformed to the determination of loss. The proposal corrects this inconsistency with respect to contracts not satisfying a 20-pay model.

In addition, concerns have been raised that some insurance companies may be taking aggressive positions with respect to mortality and expense charges. Specifically, companies may be overstating mortality and expense charges and then rebating them to policyholders. It is appropriate to clarify that such practices are not reasonable with respect to any life insurance contract.

Effective Date

The proposal generally would be effective for amounts attributable to premiums paid on or after June 21, 1988.

4. Accelerate corporate estimated tax payments

Present Law

Under present law, corporations are required to make estimated tax payments four times a year (sec. 6655). For small corporations, each installment is required to be based on an amount equal to the lesser of (1) 90 percent of the tax shown on the return or (2) 100 percent of the tax shown on the preceding year's return. For large corporations, each installment is required to be based on an amount equal to 90 percent of the tax shown on the return (except that the first payment may be based on 100 percent of the tax shown on the preceding year's return). For both large and small corporations, the amount of any payment is not required to exceed an amount which would be due if the total payments for the year up to the required payment equal 90 percent of the tax which would be due if the income already received during the current year were placed on an annual basis. Any reduction in a payment resulting from using this annualization rule must be made up in the subsequent payment if the corporation does not use the annualization rule for that subsequent payment. However, if the subsequent payment makes up at least 90 percent of the earlier shortfall, no penalty is imposed.

Description of Proposal

A corporation that uses the annualization method for a prior payment could be required to make up the entire shortfall (rather than 90 percent of the shortfall) in the subsequent payment in order to avoid an estimated tax penalty.

Reasons for Change

Two corporations with identical tax liabilities for a taxable year may make different total estimated tax payments if one corporation's income is steady throughout the year and the other corporation's income fluctuates. The option would eliminate the ability of corporations with fluctuating income to reduce the total amount of estimated tax payments owed for any year.

Effective Date

The provision would be effective for estimated tax payments required to be made after December 31, 1988.

5. Repeal of special rules allowing loss transfers by Alaska Native Corporations

Present Law

Corporations established under the Alaska Native Claims Settlement Act may, for taxable years beginning before 1992, file consolidated returns with subsidiary corporations under rules more liberal than the generally applicable rules. In addition, during this period no provision or principle of law may be applied to prevent use of losses or credits of a Native Corporation by its consolidated group. The effect of these provisions is to allow Native Corporations to transfer the benefit of their tax losses and credits to other corporations, which use the losses or credits to reduce their tax liability.

Description of Proposal

The special consolidation rules applicable to Alaska Native Corporations (including the rule prohibiting denial of the use of losses or credits through application of any provision or principle of law) would be repealed.

Reasons for Change

The amount of losses available for transfer by the Native Corporations during the period of special relief far exceeds the estimate of those losses when these provisions were adopted. Had Congress been aware of the true magnitude of the losses claimed and the resulting revenue impact, it would have rejected or substantially cut back on the provisions. It is therefore appropriate to repeal them at this time.

Effective Date

The provision would be effective for losses and credits arising on or after April 27, 1988. In addition, losses and credits of a Native Corporation arising before that date could not be used to offset income assigned (or attributable to property contributed) on or after that date, unless such use would be allowable without regard to the special consolidation rules.