DESCRIPTION OF MAJOR PROVISIONS CONTAINED IN THE "TAXPAYER RELIEF ACT OF 1998"

Scheduled for a Markup by the

HOUSE COMMITTEE ON WAYS AND MEANS

On

September 17, 1998

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

September 15, 1998

JCX-60-98

CONTENTS

Page

INTRODUCTION

On September 17, 1998, the House Committee on Ways and Means has scheduled a markup of certain tax cut proposals contained in the "Taxpayer Relief Act of 1998."

This document,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposals contained in the Chairman's mark.[2] Part I of this document contains family tax relief proposals; Part II contains education and infrastructure proposals; Part III contains small business and farmer tax relief proposals; Part IV contains proposals relating to the extension of certain expiring provisions; Part V contains a revenue offset proposal; and Part VI contains provisions relating to social security.

A separate document (JCX-62-98) provides estimates of the budget effects of the tax proposals.

---

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Major Provisions Contained in the "Taxpayer Relief Act of 1998"* (JCX-60-98), September 15, 1998. (References in this document to the "1997 Act" refer to the Taxpayer Relief Act of 1997.)

[2] A separate document provides a description of the Chairman's mark relating to proposed tax technical corrections. (See JCX-61-98.)

I. FAMILY TAX RELIEF PROPOSALS

A. Marriage Penalty Tax Relief

Present Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the unit's total taxable income. Although married couples may elect to file separate returns, the rate schedules and provisions are structured so that filing separate returns usually results in a higher tax than filing joint returns. Other rate schedules apply to single persons and to single heads of household.

A "marriage penalty" exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A "marriage bonus" exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose earnings are split more evenly than 70-30 suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus.

Under present law, the size of the standard deduction and the tax bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and tax bracket breakpoints for single filers are roughly 60 percent of those for joint filers.[3] With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable), which is subtracted (along with the deduction for personal exemptions) from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is indexed for inflation.

---

[3] This is not true for the 39.6-percent rate. The beginning point of this rate bracket is the same for all taxpayers regardless of filing status.

For 1999, the size of the basic standard deduction is projected to be as follows:[4]

Filing status	Basic standard deduction
Married, joint return	$7,200
Head of household return	6,350
Single return	4,300
Married, separate return	3,600

For 1999, the basic standard deduction for joint returns is projected to be 1.675 times the basic standard deduction for single returns.

Additional standard deductions

An additional standard deduction is allowed for a taxpayer who is either elderly (age 65 or over) or blind. Two additional standard deductions are allowed for a taxpayer who is elderly (age 65 or over) and blind. In the case of a joint return, these rules apply to both the husband and the wife. For example, if both taxpayers filing a joint return are both elderly and blind then they are entitled to four additional standard deductions. For 1999, the amount of each additional standard deduction is projected to be $800 for married individuals and $1,050 for singles and heads of households.[5] These amounts are indexed for inflation.

Description of Proposal

The proposal would increase the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for a single return in each taxable year beginning after December 31, 1998. For example, the basic standard deduction for a married couple filing a joint return would be increased from a projected $7,200 to $8,600 in 1999. Also, under the proposal, the basic standard deduction for a married taxpayer filing separately would be increased so that it would equal the basic standard deduction for singles and would equal one-half of the basic standard deduction for a married couple filing jointly for each taxable year beginning after December 31, 1998 (e.g., $4,300 in 1999). The basic standard deduction for a head of household would be unchanged.

Also, the proposal would increase the additional standard deduction for married individuals who are elderly or blind from $800 to $1,050 (the same amount allowed for singles

---

[4] Joint Committee on Taxation staff projections.

[5] Joint Committee on Taxation staff projections.

and heads of households). This amount would be indexed for inflation. The other rules relating to the additional standard deduction would not be changed.

Effective Date

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

B. Partial Exclusion for Interest and Dividends

Present Law

The Code states that, except as otherwise provided, "gross income means all income from whatever source derived" (sec. 61). Because there is no exclusion for interest and dividends, interest and dividends received by individuals are includible in income and subject to tax.

Description of Proposal

The proposal would provide an exclusion from income for individuals for up to $200 ($400 for married couples filing jointly) of combined interest and dividends received in a taxable year.[6]

Effective Date

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

---

[6] From 1954 until 1986, the Code (sec. 116) contained an exclusion from income (in varying amounts) for dividends. For 1981 only, that provision was also extended to interest; this proposal is generally parallel to that provision (except that this proposal makes clarifications with respect to dividends received from Regulated Investment Companies ("RICs") and Real Estate Investment Trusts ("REITs") and the interaction of this proposal with the earned income credit ("EIC") disqualified income test. The EIC clarification provides that any interest or dividends excluded from gross income under this proposal would also be disregarded for purposes of the EIC disqualified income test.) The exclusion for dividends was repealed by the Tax Reform Act of 1986.

C. Treatment of Personal Credits Under the Individual Minimum Tax

Present Law

Present law imposes a minimum tax on an individual to the extent the individual's tentative minimum tax exceeds his or her regular income tax liability. The tentative minimum tax is computed at rates of (1) 26 percent on the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent on the remaining AMTI. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The maximum tax rates on net capital gain are the same as under the regular tax. The exemption amounts are: (1) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of other unmarried individuals; and (3) $22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE and lifetime learning credits, and the D.C. homebuyer's credit). Generally these credits are reduced or eliminated for individuals with adjusted gross incomes above specified amounts. The aggregate amount of these credits which are allowable in any taxable year generally may not exceed the amount by which the individual's regular income tax liability exceeds the individual's tentative minimum tax. For families with three or more qualifying children, an additional child credit is provided which may offset the liability for social security taxes to the extent that tax liability exceeds the amount of the earned income credit. The additional child credit is reduced by the amount of the individual's minimum tax liability. A similar rule applies to the earned income credit.

Description of Proposal

The proposal would allow the nonrefundable personal tax credits to offset both the individual's regular income tax liability and the minimum tax liability. The proposal would also repeal the rule that reduces the additional child credit and the earned income credit by the amount of the minimum tax liability.

Effective Dates

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

D. Exclusion of Gain on the Sale of a Principal Residence by a Member of the Uniformed Service or the Foreign Service of the United States

Present Law

Under present law, a taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. Generally, to be eligible for the exclusion, the taxpayer must have owned the residence and used it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) which is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to members of the uniformed services or the Foreign Service of the United States. The uniform services include: the armed forces (the Army, Navy, Air Force, Marine Corp, and Coast Guard); the commissioned corps of the National Oceanic and Atmospheric Administration; and the commissioned corps of the Public Health Service.

Description of Proposal

Under the proposal, the test period for ownership and use would be suspended during certain absences due to service in the uniformed services or the Foreign Service of the United States. Specifically, the five-year period ending on the date of the sale or exchange of a principal residence would not include any periods during which the taxpayer or the taxpayer's spouse was on qualified official extended duty as a member of the uniformed services or the Foreign Service of the United States and serving at a place of duty away at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in Government furnished quarters. Extended duty would be defined as any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

Effective Date

The proposal would be effective for sales or exchanges of principal residences after the date of enactment.

II. EDUCATION AND INFRASTRUCTURE PROPOSALS

A. Permit Private Higher Education Institutions to Establish Qualified Prepaid Tuition Programs

Present Law

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools), as well as certain room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.[7]

Description of Proposal

Under the proposal, the definition of a "qualified tuition program" would be expanded to include any program established and maintained by one or more eligible educational institutions (which may be private institutions that are not State-owned) that satisfy the requirements under section 529 (other than present-law, State ownership rule).

Effective Date

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

---

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

B. Expand Exception from Arbitrage Rebate for Tax-Exempt Bonds Issued to Finance Public School Construction

Present Law

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (Code sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds for privately operated transportation facilities (airports, docks and wharves, mass transit, and high speed rail facilities), privately owned and/or provided municipal services (water, sewer, solid waste disposal, and certain electric and heating facilities), economic development (small manufacturing facilities and redevelopment in economically depressed areas), and certain social programs (low-income rental housing, qualified mortgage bonds, student loan bonds, and exempt activities of charitable organizations described in Code sec. 501(c)(3)).

Subject to limited exceptions, issuers of tax-exempt bonds are not permitted to earn and retain profits on investment of bond proceeds in a manner unrelated to the governmental purpose of the borrowing (the "arbitrage restrictions"). Profits are defined as earnings in excess of the interest paid on the bonds. The arbitrage restrictions require profits on these nonpurpose investments to be rebated to the Federal Government at 5-year intervals, with the final payment being due following redemption of the bonds.

Present law includes several exceptions to the requirement that arbitrage profits be rebated to the Federal Government:

(1) If all proceeds of an issue of tax-exempt bonds are spent for the governmental purpose of the borrowing within 6 months after the bonds are issued, no rebate is required for any profits that are earned (e.g., during the six-month period or afterwards on funds such as certain bona fide debt service funds). For governmental bonds, the 100-percent expenditure requirement for the first six months is reduced to 95 percent, if the remaining 5 percent of the proceeds is spent within one year after the bonds are issued.

(2) In the case of tax and revenue anticipation notes, which are short-term bonds issued to finance governmental cash flow deficits, no rebate is required if the amount of the borrowing does not exceed amounts determined by reference to the issuing government's projected cash flow shortfall.

(3) In the case of governmental bonds and certain private activity bonds issued to finance the construction of property owned by a governmental unit or a section 501(c)(3) organization, no rebate is required (except profits on amounts invested in reserve funds) if proceeds are spent

in a manner satisfying a 24-month "spend-down" exception (the "construction bond exception"). The construction bond exception requires expenditure of minimum amounts during each 6-month period of the 24-month period (10 percent in the first 6 months; 45 percent in the first 12 months; 75 percent in the first 18 months; and 100 percent (less retainage not exceeding 5 percent) by the end of the 24 month period). This exception further allows issuers to elect to pay a fixed penalty in lieu of calculating arbitrage profits and rebating them to the Federal Government if any of the expenditure targets are not met.

(4) In the case of governmental bonds issued by small governments, no rebate is required. "Small" governments are defined as governmental units with general taxing powers that, along with any subordinate units, issue no more than $5 million in governmental bonds during a calendar year. In calculating the $5 million issuance limit, up to $5 million of bonds to finance public school construction may be excluded, effectively increasing the issuance limit to $10 million in the case of small governments engaging in public school construction.

Description of Proposal

The proposal would liberalize the permitted expenditure period of the present-law construction bond exception in the case of bonds issued to finance the construction of public schools. Amounts spent for the acquisition and improvement of land that is functionally related and subordinate to a school the construction of which is financed with proceeds of the bond issue would be treated as spent for construction. Under the proposal, no rebate would be required on the construction proceeds of these public school construction bonds if the proceeds (less presently allowed retainage[8]) were spent within 4 years after the bonds are issued, and the following intermediate spending targets are satisfied:

(1) 10 percent or more of the construction proceeds is spent within 1 year after the bonds are issued;

(2) 30 percent or more of the construction proceeds is spent within 2 years after the bonds are issued; and

(3) 50 percent or more of the construction proceeds is spent within 3 years after the bonds are issued.

As under the present construction bond exception, issuers could elect to pay fixed penalties in lieu of calculating profits and rebating them to the Federal Government if they failed to satisfy the liberalized expenditure requirements. Further, as under the present-law exception,

---

[8] Retainage amounts would be required to be spent within 5 years after the bonds are issued.

profits earned on reasonably required reserve or replacement funds or on proceeds used other than for construction would be subject to the rebate requirement.

Effective Date

The proposal would apply to bonds issued after December 31, 1998.

C. Increase State Volume Limits on Private Activity Tax-Exempt Bonds

Present Law

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted and paid for by the governmental units (Code sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds for privately operated transportation facilities (airports, docks and wharves, mass transit, and high speed rail facilities), privately owned and/or provided municipal services (water, sewer, solid waste disposal, and certain electric and heating facilities), economic development (small manufacturing facilities and redevelopment in economically depressed areas), and certain social programs (low-income rental housing, qualified mortgage bonds, student loan bonds, and exempt activities of charitable organizations described in Code sec. 501(c)(3)).

The volume of tax-exempt private activity bonds that States and local governments may issue for most of these purposes in each calendar year is limited by State-wide volume limits. The current annual volume limits are $50 per resident of the State or $150 million if greater. The volume limits do not apply to private activity bonds to finance airports, docks and wharves, certain governmentally owned, but privately operated solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain "new" empowerment zone and enterprise community bonds).

Description of Proposal

The proposal would increase the present-law annual State private activity bond volume limits to $75 per resident of each State, or $225 million if greater.

Effective Date

The proposal would be effective beginning in calendar year 1999.

III. SMALL BUSINESS AND FARMER TAX RELIEF PROPOSALS

A. Acceleration of Increased Exemption from Estate and Gift Tax

Present Law

Increase in exemption from estate and gift tax

Exemptions from the Federal estate and gift tax are provided by allowing reduction of the estate or gift tax by a credit, called the unified credit. The 1997 Act increased the present-law unified credit beginning in 1998, from an effective exemption of $600,000 in 1997 to an effective exemption of $1,000,000 in 2006. The increase in the effective exemption (called the "applicable exemption amount") is phased in according to the following schedule: the effective exemption is $625,000 for decedents dying and gifts made in 1998; $650,000 in 1999; $675,000 in 2000 and 2001; $700,000 in 2002 and 2003; $850,000 in 2004; $950,000 in 2005; and $1 million in 2006 and thereafter. The applicable exemption amount is not indexed for inflation.

Deduction for interests in certain family-owned business

In addition, the 1997 Act provided a limited deduction for Federal estate tax purposes for certain family-owned business interests. The deduction for family-owned business interests may be taken only to the extent that the exclusion for family-owned business interests, plus the applicable exemption amount, does not exceed $1.3 million. Under this provision, if an executor elects to utilize the qualified family-owned business deduction, the estate tax liability is calculated as if the estate were allowed a maximum qualified family-owned business deduction of $675,000 and an applicable exemption amount of $625,000, regardless of the year in which the decedent dies. If the estate includes less than $675,000 of qualified family-owned business interests, the applicable exemption amount is increased on a dollar-for-dollar basis, but only up to the applicable exemption amount generally available for the year of death. The family-owned business deduction is not indexed for inflation.

Description of Proposal

The proposal would accelerate the scheduled increases in the applicable exemption amount such that the equivalent exemption would be $1,000,000 for decedents dying and gifts made after 1998.

Effective Date

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

B. Increase Deduction for Health Insurance Expenses of Self-Employed Individuals

Present Law

Under present law, self-employed individuals are entitled to deduct a portion of the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents. The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. The deduction is available in the case of self insurance as well as commercial insurance. The self-insured plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

The portion of health insurance expenses of self-employed individuals that is deductible is 45 percent for taxable years beginning in 1998 and 1999, 50 percent for taxable years beginning in 2000 and 2001, 60 percent for taxable years beginning in 2002, 80 percent for taxable years beginning in 2003, 2004, and 2005, 90 percent for taxable years beginning in 2006, and 100 percent for taxable years beginning in 2007 and thereafter.

Under present law, employees can exclude from income 100 percent of employer-provided health insurance.

Description of Proposal

The proposal would increase the deduction for health insurance of self-employed individuals to 100 percent for taxable years beginning in 1999 and thereafter.

Effective Date

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

C. Accelerate Increase in Expensing for Small Businesses

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $18,500 (for taxable years beginning in 1998) of the cost of qualifying property placed in service for the taxable year (sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $18,500 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

The $18,500 amount is increased to $25,000 for taxable years beginning in 2003 and thereafter. The increase is phased in as follows: for taxable years beginning in 1999, the amount is $19,000; for taxable years beginning in 2000, the amount is $20,000; for taxable years beginning in 2001 or 2002, the amount is $24,000; and for taxable years beginning in 2003 and thereafter, the amount is $25,000.

Description of Proposal

The proposal would provide that the maximum dollar amount that may be deducted under section 179 is increased to $25,000 for taxable years beginning in 1999 and thereafter, without the present-law phase-in rule.

Effective Date

The proposal would be effective for taxable years beginning in 1999 and thereafter.

D. Permanent Extension of Income Averaging for Farmers

Present Law

The 1997 Act included a provision that allows individuals engaged in the trade or business of farming an election to calculate their current year regular income tax liability by averaging, over the prior three-year period, all or a portion of their taxable income attributable to the farming business.

Under the provision, a taxpayer (1) designates all or a portion of the current year income from the farming business as "elected farm income," (2) allocates one-third of the "elected farm income" to each of the prior three taxable years, and (3) determines the current year regular income tax liability by determining the sum of (a) his or her current year income tax liability (without the elected farm income) plus (b) the increases in the income tax liability for each of the three prior taxable years by taking into account the allocable share of the elected farm income for those years.

The provision does not apply for purposes of the self-employment tax or the alternative minimum tax. The provision is effective for taxable years beginning after December 31, 1997, and before January 1, 2001.

Description of Proposal

The proposal would make permanent the income averaging provision for farmers.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2000.

E. Extend the Net Operating Loss Carryback Period for Farmers

Present Law

The net operating loss ("NOL") of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) may be carried back two years and carried forward 20 years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. In the case of NOLs arising from (1) casualty or theft losses of individual taxpayers, or (2) losses incurred in a Presidentially declared disaster area by taxpayers engaged in a farming business or a small business, such NOLs can be carried back three years. For this purpose, a "farming business" is defined as in section 263A(e)(4). Other special rules apply to real estate investment trusts (REITs) (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

Description of Proposal

The proposal would allow NOLs attributable to a farming business to be carried back five years, whether or not incurred in a Presidentially declared disaster area. The carryforward period would remain at 20 years. A taxpayer may elect to not apply the 5-year carryback period. The NOL rule attributable to a farming business would be coordinated with the other NOL rules.

Effective Date

The proposal would be effective for net operating losses arising in taxable years beginning after December 31, 1997.

F. Accelerated Production Flexibility Contract Payments Not Included in Income Prior to Receipt

Present law

A cash basis taxpayer includes an item in income at the time of its actual or constructive receipt. If a cash basis taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.

The Agricultural Market Transition Act provides for annual payments to certain farmers. These payments are made at specified times during the fiscal year. The Emergency Farm Financial Relief Act of 1998 provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Amounts that would otherwise be paid after December 31, 1998 can be specified for payment in calendar year 1998. This potentially results in the constructive receipt (and thus inclusion in taxable income) of such amounts in calendar year 1998, whether or not the amounts are actually received.

Description of Proposal

Agricultural Market Transition Act payments for fiscal year 1999 would not be included in income until actually received.

Effective Date

The proposal would be effective for Agricultural Market Transition Act payments for fiscal year 1999.

G. Designation of 20 Renewal Communities

Present Law

In general

Zones and communities designated under OBRA 1993

Pursuant to the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993"), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas and three empowerment zones are located in rural areas.[9] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392).

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of section 179 expensing for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to $38,000 of expensing for 1997); (3) special tax-exempt financing for certain zone facilities (described in more detail below); and (4) the so-called "brownfields" tax incentive, which allows taxpayers to expense (rather than capitalize) certain environmental remediation expenditures.[10]

---

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

[10] The environmental remediation expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site, generally meaning any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance. Targeted areas include: (1) empowerment zones and enterprise communities as designated under OBRA 1993 and the 1997 Act (including any supplemental empowerment zone designated on December 21, 1994); (2) sites announced before February 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract

The 95 enterprise communities are eligible for the special tax-exempt financing benefits and "brownfields" tax incentive, but not the other tax incentives (i.e., the wage credit and additional sec. 179 expensing) available in the empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

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

Additional zones designated under 1997 Act

Two additional urban zones with same tax incentives as previously designated empowerment zones.--Pursuant to the Tax Relief Act of 1997 ("1997 Act"), the Secretary of HUD is authorized to designate two additional empowerment zones located in urban areas (thereby increasing to eight the total number of empowerment zones located in urban areas) with respect to which the same tax incentives generally apply (i.e., the wage credit, additional expensing, special tax-exempt financing, and "brownfields" incentive) as are available within the empowerment zones authorized by OBRA 1993.[11] The two additional empowerment zones are subject to the same eligibility criteria under present-law section 1392 that apply to the original six urban empowerment zones.[12]

The two additional empowerment zones must be designated within 180 days after enactment of the 1997 Act (i.e., the designations must be made by February 1, 1998). However, a special rule provides that the designations of these two additional empowerment zones will not take effect until January 1, 2000 (and generally will remain in effect for 10 years).

---

with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. The "brownfields" provision (enacted in the 1997 Act) applies to eligible expenditures incurred in taxable years ending after date of enactment and before January 1, 2001.

[11] The wage credit available in the two new urban empowerment zones is modified slightly to provide that the credit rate will be 20 percent for calendar years 2000-2004, 15-percent for calendar year 2005, 10 percent for calendar year 2006, and five percent for calendar year 2007. No wage credit will be available in the two new urban empowerment zones after 2007.

[12] In order to permit designation of these two additional empowerment zones, the 1997 Act increased the aggregate population cap applicable to urban empowerment zones from 750,000 to a cap of one million aggregate population for the eight urban empowerment zones.

20 additional urban and rural empowerment zones.--The 1997 Act also authorizes the Secretaries of HUD and Agriculture to designate an additional 20 empowerment zones (no more than 15 in urban areas and no more than five in rural areas).[13] With respect to these additional empowerment zones, the present-law eligibility criteria are expanded slightly in comparison to the eligibility criteria provided for by OBRA 1993. First, the general square mileage limitations (i.e., 20 square miles for urban areas and 1,000 square miles for rural areas) are expanded to allow the empowerment zones to include an additional 2,000 acres. This additional acreage, which could be developed for commercial or industrial purposes, is not subject to the poverty rate criteria and may be divided among up to three noncontiguous parcels. In addition, the general requirement that at least half of the nominated area consists of census tracts with poverty rates of 35 percent or more does not apply to the 20 additional empowerment zones. However, under present-law section 1392(a)(4), at least 90 percent of the census tracts within a nominated area must have a poverty rate of 25 percent or more, and the remaining census tracts must have a poverty rate of 20 percent or more.[14] For this purpose, census tracts with populations under 2,000 are treated as satisfying the 25-percent poverty rate criteria if (1) at least 75 percent of the tract was zoned for commercial or industrial use, and (2) the tract is contiguous to one or more other tracts that actually have a poverty rate of 25 percent or more.[15]

Within the 20 additional empowerment zones, qualified "enterprise zone businesses" are eligible to receive up to $20,000 of additional section 179 expensing[16] and to utilize special tax-exempt financing benefits. The "brownfields" tax incentive (described above) also is available within all designated empowerment zones. However, businesses within the 20 additional empowerment zones are not eligible to receive the present-law wage credit available within the 11 other designated empowerment zones (i.e., the wage credit is available only within

---

[13] In contrast to OBRA 1993, areas located within Indian reservations are eligible for designation as one of the additional 20 empowerment zones under the 1997 Act.

[14] In lieu of the poverty criteria, outmigration may be taken into account in designating one rural empowerment zone.

[15] A special rule enacted as part of the 1997 Act modifies the present-law empowerment zone and enterprise community designation criteria so that any zones or communities designated in the future in the States of Alaska or Hawaii will not be subject to the general size limitations, nor will such zones or communities be subject to the general poverty-rate criteria. Instead, nominated areas in either State will be eligible for designation as an empowerment zone or enterprise community if, for each census tract or block group within such area, at least 20 percent of the families have incomes which are 50 percent or less of the State-wide median family income. Such zones and communities will be subject to the population limitations under present-law section 1392(a)(1).

[16] However, the additional section 179 expensing is not available within the additional 2,000 acres allowed to be included under the 1997 Act within an empowerment zone.

the nine zones designated under OBRA 1993 and the two urban zones designated under the 1997 Act that are eligible for the same tax incentives as are available in the nine zones designated under OBRA 1993).

The 20 additional empowerment zones are required to be designated before 1999, and the designations generally will remain in effect for 10 years.[17]

Definition of "qualified zone property"

Present-law section 1397C defines "qualified zone property" as depreciable tangible property (including buildings), provided that: (1) the property is acquired by the taxpayer (from an unrelated party) after the zone or community designation took effect; (2) the original use of the property in the zone or community commences with the taxpayer; and (3) substantially all of the use of the property is in the zone or community in the active conduct of a trade or business by the taxpayer in the zone or community. In the case of property which is substantially renovated by the taxpayer, however, the property need not be acquired by the taxpayer after zone or community designation or originally used by the taxpayer within the zone or community if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed 100 percent of the taxpayer's basis in the property at the beginning of the period, or $5,000 (whichever is greater).

Definition of "enterprise zone business"

Present-law section 1397B defines the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community;[18] (2) at least 50 percent[19] of the total gross income is derived from the active conduct of a "qualified business" within a zone or community; (3) a substantial portion of the business' tangible property is used within a zone or community; (4) a substantial portion of the business' intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) less than five

---

[17] In addition, the 1997 Act also provides for special tax incentives (some of which are modeled after the empowerment zone tax incentives, but which also include a zero percent capital gains rate for certain qualified assets) for the District of Columbia.

[18] A qualified proprietorship is not required to meet the requirement that the sole trade or business of the proprietor is the active conduct of a qualified business within the empowerment zone or enterprise community.

[19] The 1997 Act reduced this threshold from 80 percent (as enacted in OBRA 1993) to 50 percent.

percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.[20] In addition, the leasing of real property that is located within the empowerment zone or community to others is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses.[21] The rental of tangible personal property to others is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone or enterprise community.

Tax-exempt financing rules

Tax-exempt private activity bonds may be issued to finance certain facilities in empowerment zones and enterprise communities. These bonds, along with most private activity bonds, are subject to an annual private activity bond State volume cap equal to $50 per resident of each State, or (if greater) $150 million per State. However, a special rule (enacted in the 1997 Act) provides that certain "new empowerment zone facility bonds" issued for qualified enterprise zone businesses in the 20 additional empowerment zones are not subject to the State private activity bond volume caps or the special limits on issue size generally applicable to qualified enterprise zone facility bonds.[22]

Qualified enterprise zone facility bonds are bonds 95 percent or more of the net proceeds of which are used to finance (1) "qualified zone property" (as defined above[23]) the principal user

---

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

[21] The 1997 Act provides that the lessor of property may rely on a lessee's certification that such lessee is an enterprise zone business.

[22] The maximum amount of "new empowerment zone facility bonds" that can be issued is limited to $60 million per rural zone, $130 million per urban zone with a population of less than 100,000, and $230 million per urban zone with a population of 100,000 or more.

[23] A special rule (enacted in the 1997 Act) relaxes the rehabilitation requirement for financing existing property with qualified enterprise zone facility bonds. In the case of property which is substantially renovated by the taxpayer, the property need not be acquired by the taxpayer after zone or community designation and need not be originally used by the taxpayer within the zone if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed 15 percent of the taxpayer's basis at the

of which is an "enterprise zone business" (also defined above[24]), or (2) functionally related and subordinate land located in the empowerment zone or enterprise community.[25] These bonds may only be issued while an empowerment zone or enterprise community designation is in effect.

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

Description of Proposal

The proposal would authorize the designation of 20 "renewal communities" within which special tax incentives would be available. The following is a description of the designation process and the tax incentives that would be available within the proposed renewal communities.

Designation process

Designation of 20 renewal communities.--Under the proposal, the Secretary of HUD would be authorized to designate up to 20 "renewal communities" from areas nominated by States and local governments. At least 20 percent of the designated communities must be in rural areas (defined as areas which (1) are within local government jurisdictions with a population less than

---

beginning of the period, or $5,000 (whichever is greater).

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

A special rule (enacted in the 1997 Act) waives the requirements of an enterprise zone business (other than the requirement that at least 35 percent of the business' employees be residents of the zone or community) for all years after a prescribed testing period equal to the first three taxable years after the startup period.

[25] A special rule (enacted in the 1997 Act) waives until the end of a "startup period" the requirement that 95 percent or more of the proceeds of a bond issue be used by a qualified enterprise zone business. With respect to each property, the startup period would end at the beginning of the first taxable year beginning more than two years after the later of (1) the date of the bond issue financing such property, or (2) the date the property was placed in service (but in no event more than three years after the date of bond issuance). This waiver is available only if, at the beginning of the startup period, there is a reasonable expectation that the use by a qualified enterprise zone business will be satisfied at the end of the startup period and the business makes bona fide efforts to satisfy the enterprise zone business definition.

50,000, (2) are outside of a metropolitan statistical area, or (3) are determined by HUD to be a rural area). The Secretary of HUD would be required to publish (within four months after enactment) regulations describing the selection process, and all designations of renewal communities would have to be made within 24 months after such regulations are published. Designations generally would remain in effect through December 31, 2006.

Old empowerment zones and enterprise communities could seek additional designation as renewal communities.--The proposal would allow the previously designated empowerment zones and enterprise communities to apply for designation as renewal communities. Priority would be given in the designation of the first 50 percent of renewal communities to nominated areas which are empowerment zones or enterprise communities under present law and which otherwise meet the requirements of the proposal for designation as a renewal community. If a previously designated empowerment zone or enterprise community is selected as one of the 20 renewal communities, then the area's designation as a empowerment zone or enterprise community would remain in effect and the same area would also be designated as a renewal community. For such an area obtaining dual-designation status, the special tax incentives available for empowerment zones (or enterprise communities, as the case may be) and for renewal communities would be available. If an area previously designated as an empowerment zone or enterprise community does not seek designation (or is not selected by the Secretary of HUD) as a renewal community, then the present-law empowerment zone and enterprise community provisions would continue to apply to that area.

Eligibility criteria.--To be designated as a renewal community, a nominated area would be required to meet all of the following criteria: (1) each census tract must have a poverty rate of at least 20 percent; (2) at least 70 percent of the households have incomes below 80 percent of the median income of households within the local government jurisdiction; (3) the unemployment rate is at least 1.5 times the national unemployment rate; and (4) the area is one of pervasive poverty, unemployment, and general distress.

Except with respect to the designation of the first 50 percent of renewal communities when priority would be given to existing empowerment zones and enterprise communities (as described above), those areas with the highest average ranking of factors (1), (2), and (3) above would be designated as renewal communities. The Secretary of HUD could also take into account in selecting areas for designation the extent to which such areas have a high incidence of crime, as well as whether the area has census tracts identified in the May 12, 1998, report of the Government Accounting Office regarding the identification of economically distressed areas.

There would be no geographic size or maximum population limitations placed on the designated renewal communities. The proposal merely would require that the boundary of a designated community be "continuous" and that the designated community have a population of at least 4,000 if the community is located within a metropolitan statistical area (at least 1,000 in all other cases, or the community must be entirely within an Indian reservation).

Required State and local government course of action.--In order for an area to be designated as a renewal community, the proposal would require State and local governments to submit a written course of action which promises within the nominated area at least five of the following: (1) a reduction of tax rates or fees; (2) an increase in the level of efficiency of local services; (3) crime reduction strategies; (4) actions to remove or streamline governmental requirements; (5) involvement by private entities and community groups, such as to provide jobs and job training and financial assistance; (6) State or local income tax benefits for fees paid for services performed by a nongovernmental entity which were formerly performed by a government entity; and (7) the gift (or sale at below fair market value) of surplus realty by the State or local government to community organizations or private companies.

In addition, the proposal would require that the nominating State and local governments promise to promote economic growth in the nominated area by repealing or not enforcing (1) licensing requirements for occupations that do not ordinarily require a professional degree, (2) zoning restrictions on home-based businesses which do not create a public nuisance, (3) permit requirements for street vendors who do not create a public nuisance, (4) zoning or other restrictions that impede the formation of schools or child care centers, and (5) franchises or other restrictions on competition for businesses providing public services, including but not limited to taxicabs, jitneys, cable television, or trash hauling, unless such regulations are "well-tailored to the protection of health and safety."

Tax incentives for renewal communities

The following tax incentives generally would be available during the seven-year period beginning January 1, 2000 and ending December 31, 2006.

100-percent capital gain exclusion.--The proposal would provide for a 100 percent capital gains exclusion for long-term capital gain from the sale of a qualified community asset acquired after December 31, 1999 and before January 1, 2007, and held for more than five years. A "qualified community asset" would include: (1) qualified community stock (meaning original-issue stock purchased for cash in a "renewal community business," which is similar to the present-law definition of an "enterprise zone business"); (2) qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); and (3) qualified community business property (meaning tangible real and personal property used in a renewal community business if acquired (or substantially improved) by the taxpayer after January 1, 2000). Property would continue to be a "qualified community asset" if sold (or otherwise transferred) to a subsequent purchaser, provided that the property continues to represent an interest in (or is tangible property used in) a renewal community business. The termination of an area's status as a renewal community would not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2000 and after December 31, 2006 would not be eligible for the 100-percent capital gains exclusion.

Family development accounts.--Under the proposal, individual taxpayers would be allowed to claim an above-the-line deduction for certain amounts paid in cash to a family development account ("FDA") established for the benefit of a "qualified individual," meaning an individual who both resides in a renewal community throughout the taxable year and was allowed to claim the earned income tax credit (EITC) during the preceding taxable year. A qualified individual may claim a deduction of up to $2,000 per year for amounts he/she contributes to his/her own FDA. Any other person may deduct up to $1,000 per year for amounts contributed to an FDA established on behalf of a qualified individual. Contributions to an FDA made on or before April 15th of a taxable year could be treated as made during the preceding taxable year. The proposal would permit (but not require) individuals to direct that the IRS directly deposit their EITC refunds into an FDA on behalf of such individual.

The proposal would provide that an FDA is exempt from taxation (other than the unrelated business income tax imposed by present-law section 511). Distributions from an FDA generally would be included in the gross income of the distributee (and would be subject to an additional 10-percent penalty tax[9]), but not if the distribution is used exclusively to pay (1) qualified post-secondary educational expenses, (2) certain first-home purchase costs, (3) certain qualified business capitalization costs approved by a financial institution or by a nonprofit loan fund, or (4) qualified medical expenses. Such qualified expenses must be incurred on behalf of the FDA account holder, or the spouse or dependent of the account holder.

In addition, the proposal would permit tax-free (and penalty-free) rollovers of amounts in an FDA into another such account established for the benefit of an individual who (1) both resides in a renewal community throughout the taxable year and was allowed to claim the earned income tax credit during the preceding taxable year, and (2) either is a spouse or dependent of the account holder.

The proposal also would provide that up to 25 percent of the renewal communities also will be designated by the Secretary of HUD as "FDA matching demonstration areas," with respect to which HUD would match amounts contributed to FDAs, up to $1,000 per individual per taxable year (with a $2,000 lifetime cap). The matching grant amounts made under this demonstration program would be excluded from the gross income of the account holder, and no deduction would be allowed for matching grant amounts. A 100-percent penalty would be imposed on a non-qualified distribution to the extent the distribution is attributable to the HUD matching contributions.

Commercial revitalization credit.--The proposal would allow taxpayers to claim a nonrefundable "commercial revitalization credit" (electing either (a) a 20-percent credit rate for

---

[9] Penalty taxes would not be imposed, however, if a distribution is made after the account holder becomes 59 and ½ years old, or is made due to the death or disability of the account holder.

the year a qualified building is placed in service or (b) a five-percent credit rate for each year during a 10-year period after the building is placed in service) for costs (up to $10 million per building) of constructing or substantially rehabilitating one or more buildings used for commercial purposes in a designated renewal community, including costs for the acquisition of land in connection with such buildings. A qualified building must be located in a renewal community and placed in service after December 31, 1999, and before January 1, 2007. Under the proposal, each State would be allowed to allocate no more than $2 million worth of credits to each renewal community located within the State for each calendar year.

Additional section 179 expensing.--A renewal community business (which is similar to the present-law definition of an enterprise zone business) would be allowed an additional $35,000 of section 179 expensing for qualified renewal property placed in service after an area is designated a renewal community. Thus, if a renewal community business is located in an area that is designated as both an empowerment zone and a renewal community, such business could be allowed an additional $55,000 of section 179 expensing (i.e., $20,000 of additional expensing because the area is designated an empowerment zone plus $35,000 of additional expensing because the area is designated a renewal community). As under present law, the section 179 expensing allowed to a taxpayer is phased out if the cost of section 179 property placed in service during the year by the taxpayer exceeds $200,000.

Expensing of environmental remediation costs ("brownfields").--Under the proposal, taxpayers could elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The expenditure must be incurred in connection with the abatement or control of environmental contaminants, as required by Federal and State law, at a trade or business site located within a designated renewal community. This proposal is substantially similar to the "brownfields" provision enacted as part of the 1997 Act, which allows taxpayers to expense certain environmental remediation expenditures on property located in an empowerment zone, enterprise community, or certain other designated areas. This provision would apply to expenditures incurred after December 31, 1999, and before January 1, 2007.

Extension of work opportunity tax credit.-- The proposal would provide the Work Opportunity Tax Credit ("WOTC") on an elective basis for eligible employers who hire individuals from one or more targeted groups that live and perform substantially all their work in a renewal community. It would do this by extending the expiration date of the WOTC for such employees to December 31, 2006.[10] Eligible employers would be those with a trade or business in a renewal community. The credit generally equals 40 percent (25 percent for employment of less than 400 hours) of qualified wages. Qualified wages consist of wages earned during the one-year period beginning with the day the individual begins work for the employer. Generally, no more

---

[10] The Work Opportunity Tax Credit expired July 1, 1998. A different section of the proposal would extend the Work Opportunity Tax Credit through February 29, 2000.

than $6,000 of wages is permitted to be taken into account with respect to any individual during the first year of employment. Thus, the maximum credit per individual is $2,400. With respect to qualified summer youth employees, the maximum credit generally is 40 percent of up to $3,000 of qualified first-year wages, for a maximum credit of $1,200.

Targeted groups eligible for the credit include: (1) certain individuals certified by the designated local employment agency as being a member of a family eligible to receive benefits under AFDC or its successor program; (2) certain ex-felons having a hiring date within one year of release from prison or date of conviction; (3) individuals who are at least 18 but not 25 years of age and have a principal place of abode within an empowerment zone, enterprise community, or renewal community; (4) individuals who are at least 18 but not 25 years of age who are certified as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date; (5) individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services; (6) individuals who are 16 or 17 years of age, perform services during any 90-day period between May 1 and September 15, and have a principal place of abode within an empowerment zone, enterprise community, or renewal community; (7) certain veterans who receive food stamps; and (8) recipients of certain ("SSI") Supplemental Security Income benefits.

Effective Date

Although renewal communities would be designated within 24 months after publication of certain regulations by HUD, the tax benefits available in renewal communities generally would be effective for the 7-year period beginning January 1, 2000, and ending December 31, 2006.

IV. EXTENSION OF EXPIRING PROVISIONS

A. Extension of Research Tax Credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 1998.

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

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[11]

---

[11] A special rule is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-based percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-based percentage will be its actual ratio of qualified research expenditures to

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

Alternative incremental research credit regime

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

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").[12]

---

gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

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

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component.

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

Relation to deduction

Deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Description of Proposal

The research tax credit would be extended for the period July 1, 1998, through February 29, 2000.

In addition, the credit rate applicable under the alternative incremental credit would be increased by one percentage point per step, that is from 1.65 percent to 2.65 percent when a taxpayer's current-year research expenses exceed a base amount of 1 percent but do not exceed a base amount of 1.5 percent; from 2.2 percent to 3.2 percent when a taxpayer's current-year research expenses exceed a base amount of 1.5 percent but do not exceed a base amount of 2 percent; and from 2.75 percent to 3.75 percent when a taxpayer's current-year research expenses exceed a base amount of 2 percent.

Under the proposal, taxpayers would be permitted to elect the alternative incremental research credit regime under section 41(c)(4) for any taxable year beginning after June 30, 1996, and such election would apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

Effective Date

Extension of the research credit would be effective for qualified research expenditures paid or incurred during the period July 1, 1998, through February 29, 2000. The increase in the credit rate under the alternative incremental credit would be effective for taxable years beginning after June 30, 1998.

B. Extension of the Work Opportunity Tax Credit

Present Law

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The eight targeted groups are: (1) families eligible to receive benefits under the Title IV-A Temporary Assistance for Needy Families Program (the successor to the Aid to Families with Dependent Children Program); (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

The credit generally is equal to 40 percent (25 percent for employment of 400 hours or less) of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the 1-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period begins on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan.

Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is $2,400. With respect to qualified summer youth employees, the maximum credit is 40 percent of up to $3,000 of qualified first-year wages, for a maximum credit of $1,200.

In general, an individual is not to be treated as a member of a targeted group unless: (1) on or before the day the individual begins work for the employer, the employer received in writing a certification from the designated local agency that the individual is a member of a specific targeted group; or (2) on or before the day the individual is offered work with the employer, a prescreening notice is completed with respect to that individual by the employer and within 21 days after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. The prescreening notice will contain the information provided to the employer by the individual that forms the basis of the employer's belief that the individual is a member of a targeted group.

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 120 hours. The credit percentage is 25 percent for employment of 400 hours or less, assuming that the minimum employment period is satisfied with respect to that employee. For employment of more than 400 hours, the credit percentage is 40 percent.

The credit was effective for wages paid or incurred to a qualified individual who began work for an employer before July 1, 1998.

Description of Proposal

The proposal would extend the work opportunity tax credit through February 29, 2000.

Effective Date

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

C. Extension of the Welfare-To-Work Tax Credit

Present Law

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

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

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

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before May 1, 1999.

Description of Proposal

The proposal would extend the welfare-to-work credit effective for wages paid or incurred to a qualified individual who begins work for an employer on or after May 1, 1999, and before March 1, 2000.

Effective Date

The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after May 1, 1999, and before March 1, 2000.

D. Extend the Deduction Provided for Contributions of Appreciated Stock to Private Foundations; Public Inspection of Private Foundation Annual Returns

1. Extend the deduction provided for contributions of appreciated stock to private foundations

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.[13] However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to June 30, 1998. Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

Description of Proposal

The proposal would extend permanently the special rule contained in section 170(e)(5).

Effective Date

The proposal would be effective for contributions of qualified appreciated stock to private foundations made on or after July 1, 1998.

---

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

2. Public inspection of private foundation annual returns

Present Law

Tax-exempt organizations (other than churches and certain small organizations) are required to file an annual information return (Form 990) with the Internal Revenue Service ("IRS"), setting forth the organization's items of gross income and expenses attributable to such income, disbursements for tax-exempt purposes, plus certain other information for the taxable year.

Private foundations are required to make the current year's annual information return available for public inspection at the foundation's principal office during regular business hours (sec. 6104(d)). Such return must be made available for inspection by any citizen on request made within 180 days after the date of publication of notice of its availability. Notices must be published not later than the day the return is required to be filed in a newspaper having general circulation in the county in which the principal office of the foundation is located. The notice must state that the annual return is available for public inspection by any citizen who requests it, and must state the address and telephone number of the private foundation's principal office and the name of its principal manager.

Other tax-exempt organizations that are required to file a Form 990, including public charities, are required to allow public inspection at the organization's principal office (and certain regional or district offices) of their annual information returns for the three most recent taxable years (sec. 6104(e)). In addition, upon written request to the IRS, members of the general public are permitted to inspect annual information returns of tax-exempt organizations and applications for recognition of tax-exempt status (and related documents) at the National Office of the IRS in Washington, D.C. A person making such a written request is notified by the IRS when the material is available for inspection at the National Office, where notes may be taken of the material open for inspection, photographs taken with the person's own equipment, or copies of such material obtained from the IRS for a fee (Treas. Reg. secs. 301.6104(a)-6 and 301.6104(b)-1).

The Taxpayer Bill of Rights 2 imposed an additional public inspection requirement on tax-exempt organizations that file a Form 990 (other than private foundations). Such organizations are required to comply with requests made in writing or in person from individuals who seek a copy of the organization's Form 990 or the organization's application for recognition of tax-exempt status and certain related documents. Upon such a request, the organization is required to supply copies without charge other than a reasonable fee for reproduction and mailing costs. If so requested, copies must be supplied of the Forms 990 for any of the organization's three most recent taxable years. If the request for copies is made in person, then the organization must immediately provide such copies. If the request for copies is made in writing, then copies must be provided within 30 days. However, an organization may be relieved of its obligation to provide

copies if, in accordance with regulations to be promulgated by the Secretary of Treasury, (1) the organization has made the requested documents widely available or (2) the Secretary of the Treasury determined, upon application by the organization, that the organization was subject to a harassment campaign such that a waiver of the obligation to provide copies would be in the public interest. These additional public inspection provisions generally apply to requests made no earlier than 60 days after the date on which the Treasury Department publishes the anti-harassment regulations required under the provisions.[14] While proposed regulations have been issued, final regulations have not been published; therefore, the provision is not yet in effect.[15]

Description of Proposal

Under the proposal, private foundations would be subject to the public inspection requirements of section 6104(e) that currently apply to all tax-exempt organizations that file annual information returns other than private foundations. Accordingly, private foundations would no longer be subject to the publication requirements of section 6104(d).

Effective Date

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

---

[14] However, the legislative history of the provision indicates that Congress expected that organizations will comply voluntarily with the public inspection provisions prior to the issuance of such final regulations.

[15] Prop. Treas. reg. sec. 301.6104(e)-1.

E. Exceptions Under Subpart F for Certain Active Financing Income

Present Law

In general

Under the subpart F rules, certain U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income" and insurance income. The U.S. 10-percent shareholders of a CFC also are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from the sale or exchange of (1) property that gives rise to the preceding types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; income that is equivalent to interest; income from notional principal contracts; and payments in lieu of dividends.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located with the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. Reg. sec. 1.953-1(a)).

Temporary exceptions from foreign personal holding company income and foreign base company services income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, insurance, or similar business. These exceptions (described below) are applicable only for taxable years beginning in 1998.

Income from the active conduct of a banking, financing, or similar business

A temporary exception from foreign personal holding company income applies to income that is derived in the active conduct of a banking, financing or similar business by a CFC that is predominantly engaged in the active conduct of such business. For this purpose, income derived

in the active conduct of a banking, financing or similar business generally is determined under the principles applicable in determining financial services income for foreign tax credit limitation purposes. However, in the case of a corporation that is engaged in the active conduct of a banking or securities business, the income that is eligible for this exception is determined under the principles applicable in determining the income which is treated as nonpassive income for purposes of the passive foreign investment company provisions. In this regard, the income of a corporation engaged in the active conduct of a banking or securities business that is eligible for this exception is the income that is treated as nonpassive under the regulations proposed under section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6. The Secretary of the Treasury is directed to prescribe regulations applying look-through treatment in characterizing for this purpose dividends, interest, income equivalent to interest, rents and royalties from related persons.

For purposes of the temporary exception, a corporation is considered to be predominantly engaged in the active conduct of a banking, financing or similar business if it is engaged in the active conduct of a banking or securities business or is a qualified bank affiliate or qualified securities affiliate. In this regard, a corporation is considered to be engaged in the active conduct of a banking or securities business if the corporation would be treated as so engaged under the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997); qualified bank affiliates and qualified securities affiliates are as determined under such proposed regulations. See Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6.

Alternatively, a corporation is considered to be engaged in the active conduct of a banking, financing, or similar business if more than 70 percent of its gross income is derived from such business from transactions with unrelated persons located within the country under the laws of which the corporation is created or organized. For this purpose, income derived by a qualified business unit ("QBU") of a corporation from transactions with unrelated persons located in the country in which the QBU maintains its principal office and conducts substantial business activity is treated as derived by the corporation from transactions with unrelated persons located within the country in which the corporation is created or organized. A person other than a natural person is considered to be located within the country in which it maintains an office through which it engages in a trade or business and by which the transaction is effected. A natural person is treated as located within the country in which such person is physically located when such person enters into the transaction.

Income from the active conduct of an insurance business

A temporary exception from foreign personal holding company income applies for certain investment income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization. These rules differ from the rules of section 953 of the Code, which determines the subpart F inclusions of a U.S. shareholder relating to insurance income of a CFC. Such insurance income under section 953 generally is computed in accordance

with the rules of subchapter L of the Code.

A temporary exception applies for income (received from a person other than a related person) from investments made by a qualifying insurance company of its reserves or 80 percent of its unearned premiums. For this purpose, in the case of contracts regulated in the country in which sold as property, casualty or health insurance contracts, unearned premiums and reserves are defined as unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company were subject to tax under subchapter L of the Code. Thus, for this purpose, unearned premiums are determined in accordance with section 832(b)(4), and reserves for losses incurred are determined in accordance with section 832(b)(5) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts).

In the case of a contract regulated in the country in which sold as a life insurance or annuity contract, the following three alternative rules for determining reserves apply. Any one of the three rules can be elected with respect to a particular line of business.

First, reserves for such contracts can be determined generally under the rules applicable to domestic life insurance companies under subchapter L of the Code, using the methods there specified, but substituting for the interest rates in Code section 807(d)(2)(B) an interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term applicable Federal interest rate ("AFR") (within the meaning of section 1274(d)).

Second, the reserves for such contracts can be determined using a preliminary term foreign reserve method, except that the interest rate to be used is the interest rate determined for the country in which the qualifying insurance company was created or organized, calculated in the same manner as the mid-term AFR. If a qualifying insurance company uses such a preliminary term method with respect to contracts insuring risks located in the country in which the company is created or organized, then such method is the method that applies for purposes of this election.

Third, reserves for such contracts can be determined to be equal to the net surrender value of the contract (as defined in section 807(e)(1)(A)).

In no event can the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe or deficiency reserve. This rule applies whether the contract is regulated as a property, casualty, health, life insurance, annuity or any other type of contract.

A temporary exception from foreign personal holding company income also applies for income from investment of assets equal to: (1) one-third of premiums earned during the taxable year on insurance contracts regulated in the country in which sold as property, casualty, or health

insurance contracts; and (2) the greater of 10 percent of reserves, or, in the case of a qualifying insurance company that is a startup company, $10 million. For this purpose, a startup company is a company (including any predecessor) that has not been engaged in the active conduct of an insurance business for more than 5 years. In general, the 5-year period commences when the foreign company first is engaged in the active conduct of an insurance business. If the foreign company was formed before being acquired by the U.S. shareholder, the 5-year period commences when the acquired company first was engaged in the active conduct of an insurance business. In the event of the acquisition of a book of business from another company through an assumption or indemnity reinsurance transaction, the 5-year period commences when the acquiring company first engaged in the active conduct of an insurance business, except that if more than a substantial part (e.g., 80 percent) of the business of the ceding company is acquired, then the 5-year period commences when the ceding company first engaged in the active conduct of an insurance business. Reinsurance transactions among related persons may not be used to multiply the number of 5-year periods.

Under rules prescribed by the Secretary, income is allocated to contracts as follows. In the case of contracts that are separate-account-type contracts (including variable contracts not meeting the requirements of sec. 817), only the income specifically allocable to such contracts are taken into account. In the case of other contracts, income not specifically allocable is allocated ratably among such contracts.

A qualifying insurance company is defined as any entity which: (1) is regulated as an insurance company under the laws of the country in which it is incorporated; (2) derives at least 50 percent of its net written premiums from the insurance or reinsurance of risks situated within its country of incorporation; and (3) is engaged in the active conduct of an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

The temporary exceptions do not apply to investment income (includable in the income of a U.S. shareholder of a CFC pursuant to sec. 953) allocable to contracts that insure related party risks or risks located in a country other than the country in which the qualifying insurance company is created or organized.

Anti-abuse rule

An anti-abuse rule applies for purposes of these temporary exceptions. For purposes of applying these exceptions, items with respect to a transaction or series of transactions are disregarded if one of the principal purposes of the transaction or transactions is to qualify income or gain for these exceptions, including any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions.

Foreign base company services income

A temporary exception from foreign base company services income applies for income derived from services performed in connection with the active conduct of a banking, financing, insurance or similar business by a CFC that is predominantly engaged in the active conduct of such business or is a qualifying insurance company.

Description of Proposal

In general

The proposal would modify the present-law temporary exceptions from subpart F for income that is derived in the active conduct of a banking, financing, insurance or similar business. These exceptions (as modified) would be applicable only for taxable years beginning in 1999.

With respect to income derived in the active conduct of a banking, financing, or similar business, the proposal differs from the present-law temporary exceptions in the following significant respects. First, the proposal would require a CFC to conduct substantial activity with respect to its business in order to qualify for the exceptions. Second, the proposal would add certain nexus requirements which would require that income which is derived by a CFC or QBU from transactions with customers would be eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Third, the proposal would modify the tests for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business, including modifications for income derived from a lending or finance business. Fourth, the proposal would extend the exceptions to income derived from certain cross-border transactions, provided that certain requirements are met. Fifth, the determination of where a customer is treated as located would be made under rules prescribed by the Secretary of the Treasury. Finally, the look-through rule that was included in the present-law provision for purposes of determining the income eligible for the exceptions would be eliminated.

In the case of insurance, the proposal differs from present law in the following significant respects. In addition to the exception for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization that is provided under present law, the proposal would provide additional exceptions. First, the proposal would provide temporary exceptions from insurance income and from foreign personal holding company income for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, the proposal would add additional temporary exceptions from insurance income and from foreign personal holding company income for certain income of certain CFCs or branches with respect to risks located in any country other than the U.S., provided

that requirements for these exceptions are met.

Income from the active conduct of a banking, financing or similar business

Substantial activity requirement

The proposal would modify the exceptions from subpart F for income derived in the active conduct of a banking, financing, or similar business by, among other things, incorporating a substantial activity requirement. Under the proposed modifications, the subpart F exceptions would apply to a CFC that is an eligible controlled foreign corporation (an "eligible CFC"). An eligible CFC would be defined as a CFC which is predominantly engaged in the active conduct of a banking, financing, or similar business, but only if it conducts substantial activity with respect to such business.

Whether a CFC would be considered to conduct substantial activity with respect to a banking, financing, or similar business would be determined under all the facts and circumstances. It would be intended that as part of this facts and circumstances analysis in determining whether the activities conducted by the CFC are substantial, all relevant factors would be taken into account, including the overall size of the CFC, the amount of its revenues and expenses, the number of its employees, the ratio of its revenues per employee, the amount of property it owns, and the nature, size, and relevant significance of the applicable activities conducted by the CFC. Under the proposal, the Secretary would be granted the authority to prescribe regulations to carry out the purposes of these exceptions. It would be intended that such authority would include the authority to prescribe regulations relating to whether a CFC (or, as relevant, a QBU) would be considered to conduct substantial activity.

It also would be intended that as part of this facts and circumstances analysis, a CFC would be required to conduct substantially all of the activities necessary for the generation of income with respect to the business, which generally would include the following:

- initial solicitation of customers (including vendors);
- advising customers on financial needs, including funding and financial products;
- providing financial and technical advice to customers;
- designing or tailoring financial products to customers' needs;
- negotiating terms with customers;
- performing credit analysis on customers and evaluating noncredit risks;
- providing related services to customers;

- making loans, entering into leases, extending credit or entering into other transactions with customers that generate income that would be considered derived in the active conduct of a banking, financing, or similar business;

- collecting from customers;

- performing remarketing activities (including sales) following termination of transactions with customers;

- responding to customers' failure to satisfy their obligations under transactions, including enforcement or renegotiation of terms, liquidation of collateral, foreclosure, and/or institution of litigation; and

- holding collateral for transactions with customers.

It would be intended that the performance of back-office functions (including accounting for income or loss, recordkeeping, and communicating with customers) not be taken into account in determining whether the substantial activity requirement is satisfied. It also would be intended that the relevant activities of the business may be modified by Treasury regulation to take into account future changes in the operations of these businesses.

In general, the substantial activity requirement would be applied based on the activities of the CFC as a whole, including the activities of any QBUs of the CFC. In determining whether the substantial activity requirement would be satisfied, activities performed in the country in which the CFC is incorporated (or in the country in which the QBU has its principal office) by employees of a related person of the CFC would be taken into account, to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in such country for purposes of such country's income tax laws. For this purpose, a related person would have the meaning provided in section 954(d)(3), substituting "at least 80 percent" for "more than 50 percent." It would be intended that the activities of such a related person would not again be taken into account in determining whether another CFC or QBU (e.g., the related person) satisfies the substantial activity requirement.

Predominantly engaged requirement

The proposal also would modify the rules for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Different rules would apply to banks and financing or similar businesses for this purpose.

Banking business

Under the present-law provision, a CFC is considered to be predominantly engaged in the active conduct of banking, financing, or similar business if the CFC is engaged in the active conduct of a banking business within the meaning of section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997), or is a qualified bank affiliate within the meaning of the proposed regulations under former section 1296(b). See Prop. Treas. Reg. sec. 1.1296-4. The proposal would modify the application of the banking business test for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing or similar business. Under the proposal, a CFC would be considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if it is engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States (or is any other corporation not so licensed which is specified in regulations). In this regard, it generally would be intended that these requirements for the active conduct of a banking business would be interpreted in the manner provided in the regulations proposed under former section 1296(b). See Prop. Treas. Reg. sec. 1.1296-4. However, it would not be intended that this requirement be considered to be satisfied by a CFC merely because it is a qualified bank affiliate within the meaning of the proposed regulations under former section 1296(b).

Lending or finance business

Under the present-law provision, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if more than 70 percent of its gross income is derived from such business from transactions with unrelated persons located within the CFC's country of creation or organization. For this purpose, income derived by a QBU of the CFC from transactions with unrelated persons located within the country in which the QBU maintains its principal office are taken into account in satisfying this test if the QBU conducts substantial business activity.

The proposal would modify this test for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business. Under the proposal, a CFC would be considered to be predominantly engaged in the active conduct of such business if more than 70 percent of its gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with customers which are unrelated persons. For this purpose, a CFC would be considered to be engaged in a lending or finance business if it is engaged in the business of:

(1) making loans;

(2) purchasing or discounting accounts receivable, notes, or installment obligations;

(3) engaging in leasing (including entering into leases and purchasing, servicing and

disposing of leases and leased assets);

(4) issuing letters of credit and providing guarantees;

(5) providing charge and credit card services;

(6) rendering services or making facilities available in connection with the foregoing activities carried on by the corporation rendering such services or facilities, or by another corporation which is a member of the same affiliated group.

For this purpose, whether two corporations are affiliated would be determined by reference to section 1504 with one modification: the exclusion for foreign corporations would be disregarded.

Qualified banking or financing income exempt from subpart F

In general

If the CFC would be treated as an eligible CFC (i.e., it satisfies the substantial activity and predominantly engaged requirements), the subpart F exceptions would apply to so-called qualified banking or financing income of such corporation. In general, qualified banking or financing income would be defined as income which is derived in the active conduct of a banking, financing, or similar business by an eligible CFC or a QBU of such CFC if: (1) the income is derived from transactions with customers not located in the United States, (2) substantially all of the activities in connection with such transactions are conducted directly by the corporation or unit in its home country, and (3) the income is treated as earned by such corporation or unit in its home country for purposes of such country's tax laws. For this purpose, income would be considered to be earned by a CFC or a QBU in its home country if such income is sourced and allocable to such CFC or QBU in its home country for purposes of such country's tax laws. In addition, for this purpose, activities would be considered to be conducted by a CFC or QBU if such activities are performed by employees of the CFC or QBU. Except as provided by regulations, a CFC's home country would be defined as its country of creation or organization, and a QBU's home country would be defined as the country in which the unit maintains its principal office. It would be intended that income derived from transactions with customers would apply only to transactions with customers acting in their capacity as such.

In general, qualified banking or financing income of an eligible CFC or QBU of such CFC would be determined separately for the CFC and each QBU, taking into account, in the case of an eligible CFC, only items of income, gain, deduction, loss or other items, as well as activities, of such CFC that is not properly allocable to any QBUs. Similarly, in the case of a QBU, qualified banking or financing income would be determined by taking into account such applicable items (e.g., income and activities) that are properly allocable to such QBU. Under the proposal, the Secretary would be granted the authority to prescribe regulations to carry out the purposes of

these exceptions. It would be intended that such authority would include the authority to prescribe regulations for properly allocating such items among branches or units of a CFC, and between the CFC and its branches or units.

Income from local customer transactions

If the requirements above are satisfied, the exceptions would apply to income that is derived from transactions with customers located in the CFC's home country. In addition, the exceptions would apply to income that is derived by a QBU of an eligible CFC from transactions with customers located in the QBU's home country.

For example, assume that a CFC is incorporated in the United Kingdom and has operations in France that constitute a QBU. Also assume that the activities of the U.K. CFC's head office together with the activities of the French QBU satisfy the substantial activity requirement. Under the proposal, income derived by the U.K. CFC from transactions with customers in the United Kingdom would be eligible for the exceptions if substantially all of the activities in connection with the transaction were performed in the United Kingdom by employees of the U.K. CFC, and the income was treated as earned by the U.K. CFC in the United Kingdom for U.K. income tax purposes. In addition, income derived by the French QBU from transactions with customers in France would be eligible for the exceptions if substantially all of the activities in connection with the transactions were performed in France by employees of the French QBU, and the income was treated as earned by the French QBU in France for French income tax purposes.

Income from cross border transactions

If the requirements above are satisfied, the exceptions also would apply to income from certain cross border transactions, but only if a higher standard with respect to the substantial activity requirement is satisfied. Under the proposal, income derived by a CFC from transactions with customers not located in the CFC's home country or the United States would be eligible for the exceptions if the CFC conducts substantial activity with respect to a banking, financing, or similar business in its home country. In addition, income derived by a QBU of an eligible CFC from transactions with customers not located in the QBU's home country or the United States would be eligible for the exceptions, but only if the QBU conducts substantial activity with respect to such a business in its home country. For this purpose, the substantial activity requirement would be applied by looking only at the activities of the applicable CFC or QBU on a stand-alone basis. Thus, income derived by a QBU from transactions with customers not located in its home country (or in the United States) would be eligible for the exceptions if the activities of the QBU itself constitute substantial activities (provided that the other requirements are satisfied).

Consider again the U.K. CFC and the French QBU. If the head office of the U.K. CFC

derives income from a transaction with a customer in Germany, the income would be eligible for the exceptions if the activities of the CFC itself (without regard to those of the French QBU) satisfy the substantial activity requirement. Alternatively, if the French QBU derives income from a transaction with a German customer, the income would be eligible for the exceptions if the activities of the French QBU itself satisfy the substantial activity requirement.

Home country requirement for income earned with respect to a lending or finance business

In the case of a lending or finance business, in addition to the requirements described above, the proposal would include an additional requirement to qualify for these income exceptions in the case of income earned by a CFC that is an eligible CFC which satisfies the predominantly engaged requirement for an active lending or finance business. For such an eligible CFC, income derived by such CFC would be eligible for the exceptions only if such CFC derives more than 30 percent of its gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are unrelated persons and that are located within the CFC's home country (the "home country" requirement). In addition, income derived by a QBU of such an eligible CFC would be eligible for the exceptions only if such QBU derives more than 30 percent of its gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are unrelated persons and that are located within the QBU's home country.

The home country requirement would be applied on a stand-alone basis to the particular CFC or QBU; thus, the 30 percent gross income test would take into account only the gross income of a particular CFC (without regard to the income of its QBUs) from transactions with its home-country unrelated customers, or the gross income of a particular QBU (without regard to the income of the CFC or other QBUs) from transactions with its home country unrelated customers. Accordingly, if more than 70 percent of the CFC's gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers, and one of the CFC's QBUs satisfies the home country requirement but another QBU does not satisfy such requirement, income derived by the QBU that satisfies the home country requirement would be eligible for the exceptions from subpart F (provided that the other requirements are satisfied), but income derived by the other QBU would not be eligible for the exceptions.

Exception for securities dealers

Under the present-law provision, a CFC is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if the CFC is engaged in the active conduct of a securities business within the meaning of section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997), or is a qualified securities affiliate within the meaning of the regulations proposed under former section 1296(b). See Prop. Treas. Reg. sec.

1.1296-6.

Under the proposal, the securities business test for determining whether a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business would be eliminated. In replacement of these rules, the proposal would provide an additional exception from the definition of foreign personal holding company income for certain income derived by a securities dealer within the meaning of section 475. This exception would apply to interest or dividends (or equivalent amounts described in sec. 954(c)(1)(E) or (G)) from any transaction (including a hedging transaction or a transaction consisting of a deposit of collateral or margin described in sec. 956(c)(2)(J)) entered into in the ordinary course of the dealer's trade or business as such a securities dealer, but only if the income is attributable to activities of the dealer in the country in which the dealer is created or organized (or, in the case of a QBU of the dealer, is attributable to activities of the QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity). For this purpose, income would be considered to be attributable to activities of the dealer in its country of incorporation (or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity), if such income is attributable to activities performed in such country by employees of the dealer (or QBU), and such income is treated as earned in such country by the dealer (or QBU) for purposes of such country's tax laws. For this purpose, income would be considered to be earned in the country in which the dealer is created or organized (or, in the case of a QBU, in the country in which the QBU both maintains its principal office and conducts substantial business activity), if such income is sourced and allocable to such dealer (or QBU) in such country for purposes of such country's tax laws.

Insurance income

The proposal would provide a temporary exception to insurance income under section 953. The exception does not apply to related person insurance income to which section 953(c) applies. For purposes of the exception to insurance income, reserves for any insurance or annuity contract would be determined in the same manner as under the exception, described below, for foreign personal holding company income relating to insurance (sec. 954(i), as added by the proposal). For purposes of these provisions, reserves would be intended to include discounted unpaid losses or losses incurred, as appropriate, for property and casualty contracts.

Operation of the exception

The proposal would provide an exception from insurance income for income derived by a qualifying insurance company that is attributable to the issuing (or reinsuring) of an exempt contract by the qualifying insurance company or a qualifying insurance company branch of such a company, and that is treated as earned by the company or branch in its home country for purposes of that country's tax laws. The exception from insurance income would not apply to income attributable to the issuing (or reinsuring) of an exempt contract as the result of any arrangement

whereby another corporation receives a substantially equal amount of premiums or other consideration in respect of issuing (or reinsuring a contract that is not an exempt contract). For this purpose, an exempt contract would be an insurance or annuity contract issued or reinsured by a qualifying insurance company or qualified insurance company branch in connection with property in, liability arising out of activity in, or the lives or health of residents of, a country other than the United States.

No contract would be treated as an exempt contract unless the qualifying insurance company or branch derives more than 30 percent of its net written premiums from exempt contracts (determined without regard to this sentence) covering applicable home country risks, and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (within the meaning sec. 954(d)(3)). Applicable home country risks are risks in connection with property in, liability arising out of activity in, or the lives or health of residents of, the home country of the qualifying insurance company or branch, as the case may be. In all cases, the 30 percent test is applied on a unit-by-unit basis. Accordingly, income derived by a qualifying insurance company branch of a CFC qualifies only if such branch alone satisfies the 30 percent test (without regard to the net written premiums of any other branch). Income derived by the CFC qualifies only if the CFC alone satisfies the 30 percent test without regard to the net written premiums of any other unit or branch of the CFC.

When the CFC and a branch are tested separately, then in the case of the CFC, only income and activities of the CFC not properly allocable to any QBU would be taken into account. In the case of a QBU, only income and activities of the QBU would be taken into account for this purpose. It would be intended that the Treasury Secretary prescribe rules for allocating items among QBUs and between a CFC and its QBUs.

The home country of a CFC would be the country in which the CFC is created or organized. The home country of a QBU that is a qualifying insurance company branch of a qualifying insurance company means the country in which the principal office of such unit is located and in which such unit is licensed, authorized, or regulated by the applicable insurance regulatory body to sell insurance, reinsurance or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in that country.

Qualifying insurance company

A qualifying insurance company would be a CFC that meets the following requirements. The first requirement is that the CFC be subject to regulation as an insurance (or reinsurance) company by its home country.

The second requirement is that the CFC derive more than 50 percent of its aggregate net written premiums from the insurance or reinsurance by the CFC (on an aggregate basis, including qualifying insurance company branches) covering applicable home country risks (as described

above) of the CFC or branch, as the case may be, provided that no policyholder, insured, annuitant, or beneficiary is a related person. A related person would have the meaning set forth in section 954(d)(3). In the case of a qualifying insurance company branch, premiums are taken into account under this second requirement only to the extent the premiums are treated as earned by the branch in its home country for purposes of that country's tax laws.

The third requirement is that the CFC be engaged in the insurance business and that it would be subject to tax under subchapter L if it were a domestic corporation. A CFC would be considered to be engaged in the insurance business, within the meaning of this provision, if it operates in a manner consistent with the operation of other bona fide commercial insurance companies that sell insurance products to unrelated parties in its home country, and conducts managerial activities in that country with respect to the major functions of the insurance business. For this purpose, activities performed in the home country of the CFC by employees of the CFC and of a related person would be taken into account, to the extent that the related person is compensated on a arm's length basis for the services of such employees and such compensation is includible in the related person's income in such country for purposes of that country's tax laws. For this purpose, a related person would have the meaning provided in section 954(d)(3), substituting "at least 80 percent" for "more than 50 percent." In determining whether a CFC is engaged in the insurance business, for example, an entity that is not engaged in regular and continuous transactions with persons that are not related persons (as described in the generally applicable anti-abuse rules) would not be considered as engaged in the insurance business.

The last requirement is that the CFC be licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons (within the meaning of section 954(d)(3)) in its home country.

Qualifying insurance company branch

A qualifying insurance company branch would be a qualified business unit of a CFC that meets two requirements. A qualified business unit would mean any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records (within the meaning of sec. 989(a)). The first requirement would be that the unit be licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance or annuity contracts to persons other than related persons (within the meaning of sec. 954(d)(3)) in that country. The second requirement would be that the CFC (of which the branch is a unit) be a qualifying insurance company, taking the unit into account as if it were a qualifying insurance company branch.

Additional requirements in the case of cross border risks

The proposal would impose additional requirements with respect to any contract that covers cross border risks (that is, risks other than applicable home country risks). A contract issued by a qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks would not be treated as an exempt contract unless such company or branch, as the case may be, (1) conducts substantial activity in its home country with respect to the insurance business, and (2) performs in its home country substantially all of the activities necessary to give rise to the income generated by the contract.

Whether a CFC or unit thereof would be considered to perform in its home country substantial activities with respect to the insurance business would be determined under all the facts and circumstances. It would be intended that as part of this facts and circumstances analysis in determining whether the activities conducted by the CFC or unit are substantial, all relevant factors would be taken into account, including the overall size of the CFC or unit, the amount of its revenues and expenses, the number of its employees, the ratio of its revenues per employee, the amount of property it owns, and the nature, size and significance of the applicable activities conducted by the CFC or unit. Under the proposal, the Secretary would be granted the authority to carry out the purposes of these exceptions. It would be intended that such authority would include the authority to prescribe regulations relating to whether a CFC or unit would be considered to conduct substantial activity.

It also would be intended that as part of this facts and circumstances analysis, a CFC or unit would be required to conduct substantially all of the activities necessary for the generation of income with respect to the insurance business. Such activities of an insurance business generally would depend on the line of business, and generally would include:

- designing or tailoring insurance products to meet market or customer requirements;
- performing actuarial analysis with respect to insurance products;
- performing underwriting functions with respect to insurance products;
- performing analysis for purposes of risk assessment;
- performing analysis for purposes of setting premium rates;
- performing analysis for purposes of calculating reserves;
- performing claims management and adjustment functions;
- developing marketing strategies, advertising and other public image activities;

- making (or arranging for) sales to customers;
- maintaining reserves and surplus (other than excess surplus);
- making (or arranging for) investments; and
- collecting from customers.

It would be intended that the performance of back-office functions (including accounting for income or loss, recordkeeping, and communicating with customers) not be taken into account in determining whether the substantial activity requirement is satisfied. It also would be intended that the relevant activities of the business may be modified by Treasury regulation to take into account the actual operation of lines of insurance business, and to take account of future changes in the operation of lines of insurance business.

It would be intended that activities performed in the CFC's or unit's home country by employees of a related person (within the meaning of sec. 954(d)(3), substituting "at least 80 percent" for "more than 50 percent") be taken into account, to the extent that the related person is compensated on an arm's length basis for the services of such employees and such compensation is includible in the related person's income in that country for purposes of such country's tax laws. It also would be intended that the activities of such a related person would not again be taken into account in determining whether another CFC or unit (e.g., the related person) satisfies the substantial activity requirement.

In addition, the qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks would be required to perform in its home country substantially all of the activities necessary to give rise to the income generated by the contract.

Foreign personal holding company income with respect to insurance

The proposal would provide an exception from foreign personal holding income for certain investment income derived by a qualifying insurance company and by certain qualifying insurance company branches. Income of a qualifying insurance company branch would come within this exception if the income were to satisfy the exception under the condition that such branch were treated as a qualifying insurance company whose home country is such branch's home country.

The exception applies to income (received from a person other than a related person) from investments made by a qualifying insurance company or qualifying insurance company branch of its reserves allocable to exempt contracts or 80 percent of its unearned premiums from exempt

contracts. For this purpose, an exempt contract has the meaning provided under the proposal.

In the case of exempt contracts that are property, casualty, or health insurance contracts, unearned premiums and reserves would mean unearned premiums and reserves for losses incurred determined using the methods and interest rates that would be used if the qualifying insurance company or qualifying insurance company branch were subject to tax under subchapter L of the Code, with certain modifications. For this purpose, unearned premiums and losses incurred would be determined in accordance with section 832(b) and 846 of the Code (as well as any other rules applicable to a U.S. property and casualty insurance company with respect to such amounts). However, in applying these rules, there would be substituted for the applicable Federal interest rate the interest rate determined for the functional currency of the company's or branch's home country and which (except as provided by the Treasury Secretary) is calculated in the same manner as the Federal mid-term rate under section 1274(d). In addition, there would be substituted for the loss payment pattern under section 846 the foreign loss payment pattern determined by the Treasury Secretary for the line of business.

In the case of an exempt contract that is a life insurance or annuity contract, reserves for such contracts would be determined as follows. The reserves would equal the greater of: (1) the net surrender value of the contract (as defined in section 807(e)(1)(A)), including in the case of pension plan contracts; or (2) the amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under Subchapter L of the Code, with the following modifications. First, there would be substituted for the applicable Federal interest rate an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable Federal interest rate ("AFR") (within the meaning of section 1274(d)). Second, there would be substituted for the prevailing State assumed rate the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Third, in lieu of U.S. mortality and morbidity tables, there would be applied mortality and morbidity tables that reasonably reflect the current mortality and morbidity risks in the foreign country. Fourth, the Treasury Secretary may provide that the interest rate and mortality and morbidity tables of a qualifying insurance company may be used for one or more of its branches when appropriate.

In no event would the reserve for any contract at any time exceed the foreign statement reserve for the contract, reduced by any catastrophe, equalization, or deficiency reserve or any similar reserve. This rule would apply whether the contract is regulated as a property, casualty, health, life insurance, annuity, or any other type of contract.

The proposal would also provide an exception from foreign personal holding company income for income from investment of assets equal to (1) one-third of premiums earned during the taxable year on exempt contracts regulated in the country in which sold as property, casualty, or

health insurance contracts, and (2) 10 percent of reserves (determined for purposes of the proposal) for contracts regulated in the country in which sold as life insurance or annuity contracts. In no event would the exception from foreign personal holding company income apply to investment income with respect to excess surplus.

To prevent the shifting of relatively high-yielding assets to generate investment income that qualifies under this temporary exception, the proposal would provide that, except as provided by the Treasury Secretary, income would be allocated to contracts as follows. In the case of a separate account-type contract (including a variable contract not meeting the requirements of section 817), the income credited under the contract would be allocable only to that contract. Income not so allocated would be allocated ratably among all contracts that are not separate account-type contracts.

Other definitions and anti-abuse rules relating to insurance

The proposal would provide that the present-law statutory definition of a life insurance contract (under secs. 7702 or 101(f)), as well as the distribution on death requirement of section 72(s) and the diversification requirement of section 817(h), would not apply for purposes of determining reserves for a life insurance or annuity contract under sections 953 and 954 of the Code, provided that neither the policyholders, the insureds or annuitants, nor the beneficiaries with respect to the contract are U.S. persons. In addition, the proposal would provide Treasury regulatory authority to provide for the treatment of accident and health insurance contracts generally in the same manner as a life insurance contract, where appropriate.

The anti-abuse rules applicable under the subpart F exceptions provided in section 954(h) (as added by the proposal) would apply to these exceptions for insurance. In addition, the proposal would provide anti-abuse rules applicable under the exceptions from subpart F income relating to insurance. The proposal would provide that there shall be disregarded any change in the method of computing reserves or any other transaction or transactions one of the principal purposes of which is the acceleration or deferral of any item in order to claim the benefits of these exceptions.

The proposal would provide that a contract is not treated as an exempt contract (as described above), if any policyholder, insured or annuitant, or beneficiary is a resident of the United States, the contract was marketed to the U.S. resident, and was written to cover a risk outside the United States

The proposal would provide that a contract is not treated as an exempt contract, if the contract covers risks located both within and outside the United States, and the qualifying insurance company or branch does not maintain such records, and file such reports, with respect to the contract as the Treasury Secretary requires. It would be intended that documentation that is contemporaneous with the issuance of the contract be maintained by the qualifying insurance

company or branch.

The proposal would provide that the Treasury Secretary may prescribe rules for the allocation of contracts (and income from contracts) among two or more qualifying insurance company branches of a qualifying insurance company in order to clearly reflect the income of such branches.

The proposal would provide that the Treasury Secretary may prescribe regulations similar to the regulations under section 842(d) to prevent the avoidance of the purposes of the exceptions for insurance income and foreign personal holding company income under the proposal.

Other anti-abuse rules

The proposal would include the anti-abuse rules of the present-law provision, with certain further refinements reflected under the proposal. The proposal would add an anti-abuse rule which would, for purposes of these exceptions, disregard any item of income, gain, loss or deduction with respect to certain transactions, including utilizing or doing business with an entity which is not engaged in regular and continuous transactions with customers that are unrelated persons. In addition, to the extent provided in regulations, this anti-abuse rule would apply to other transactions, including utilizing or doing business with a special purpose vehicle, including securitization vehicles, intragroup financing arrangements, or any similar entity or arrangement. The proposal also would modify the anti-abuse rule of the present-law provision relating to organizing entities in order to satisfy any same country requirement under these exceptions. The proposal would provide that to the extent provided in regulations, the anti-abuse rule would apply to transactions involving utilizing or doing business with any entity in order to satisfy any home country requirement under these exceptions.

The proposal also would provide a rule which denies customer treatment in certain cases. The proposal would provide that a person who is a related person, an officer, a director, or an employee of a CFC or QBU and who otherwise would be treated as a customer, would not be treated as a customer with respect to any transaction if a principal purpose of the transaction is to satisfy any requirement for these exceptions.

Sale of assets of an active financing business

Finally, the proposal includes a modification to address the treatment of sales of assets of an active financing business. In general, foreign personal holding company income includes net gains from the sale or exchange of property that gives rise to dividends, interest, royalties, rents, or annuities. The proposal would provide an exception from this rule for income that qualifies for the exception from subpart F for income derived in the active conduct of a banking, financing, or similar business. Under the proposal, foreign personal holding company income would not include net gains from the sale or exchange of property that gives rise to dividends, interest,

royalties, rents, or annuities if such property gives rise to income not treated as foreign personal holding company income for the taxable year by reason of the exceptions for banking, financing, or similar income under proposed section 954(h). It would be intended that this exception would apply only to the extent that the property was held to generate or generated income from the active conduct of a banking, financing, or similar business prior to its disposition (and such property was not so held for a principal purpose of taking advantage of this exception).

Exceptions from foreign base company services income

The present-law provision includes a corresponding exception from foreign base company services income for income derived by a CFC from the performance of services that are directly related to a transaction entered into by the CFC that gives rise to income that is eligible for these exceptions from subpart F. Under the proposal, foreign base company services income would not include income that is not treated as foreign personal holding company income by reason of the exceptions under proposed section 954(h) or 954(i) or the securities dealer exception under proposed section 954(c)(2)(C)(ii), or is treated as exempt insurance income by reason of proposed section 953(e).

Effective Date

The proposal would apply only to taxable years of foreign corporations beginning in 1999, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

F. Extension of the Generalized System of Preferences

Present Law

Title V of the Trade Act of 1974, as amended, grants authority to the President to provide duty-free treatment on imports of certain articles from beneficiary developing countries subject to certain conditions and limitations. To qualify for GSP privileges, each beneficiary country is subject to various mandatory and discretionary eligibility criteria. Import sensitive products are ineligible for GSP. The GSP program, which is designed to promote development through trade rather than traditional aid programs, expired after June 30, 1998.

Description of Proposal

The proposal would reauthorize the GSP program for a temporary period, to terminate after February 29, 2000. Refunds would be authorized, upon request of the importer, for duties paid between July 1, 1998, and the date of enactment of the bill.

Effective Date

The proposal would be effective for duties paid on or after July 1, 1998, and before March 1, 2000.

V. REVENUE OFFSET PROPOSAL

A. Treatment of Certain Deductible Liquidating Distributions of Regulated Investment Companies and Real Estate Investment Trusts

Present Law

Regulated investment companies ("RICs") and real estate investment trusts ("REITs") are allowed a deduction for dividends paid to their shareholders. The deduction for dividends paid includes amounts distributed in liquidation which are properly chargeable to earnings and profits. Rules that govern the receipt of dividends from RICs and REITs generally provide for including the amount of the dividend in the income of the shareholder receiving the dividend that was deducted by the RIC or REIT. Generally, any shareholder realizing gain from a liquidating distribution of a RIC or REIT includes the amount of gain in the shareholder's income. However, in the case of a liquidating distribution to a corporation owning 80-percent of the stock of the distributing corporation, a separate rule generally provides that the distribution is tax-free to the parent corporation. The parent corporation succeeds to the tax attributes, including the adjusted basis of assets, of the distributing corporation. Under these rules, a liquidating RIC or REIT might be allowed a deduction for amounts paid to its parent corporation, without a corresponding inclusion in the income of the parent corporation, resulting in income being subject to no tax.

A RIC or REIT may designate a portion of a dividend as a capital gain dividend to the extent the RIC or REIT itself has a net capital gain, and a RIC may designate a portion of the dividend paid to a corporate shareholder as eligible for the 70-percent dividends-received deduction to the extent the RIC itself received dividends from other corporations.

Description of Proposal

Any amount which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to an 80-percent corporate owner would be includible in the income of the recipient corporation. The includible amount would be treated as a dividend received from the RIC or REIT. The liquidating corporation may designate the amount treated as a dividend as a capital gain dividend or, in the case of a RIC, a dividend eligible for the 70-percent dividends received deduction, to the extent provided by the RIC or REIT provisions of the Code.

The proposal does not otherwise change the tax treatment of the distribution to the parent corporation or to the RIC or REIT. Thus, for example, the liquidating corporation will not recognize gain (if any) on the liquidating distribution and the recipient corporation will hold the assets at a carryover basis.

Effective Date

The proposal would be effective for distributions on or after May 22, 1998, regardless of when the plan of liquidation was adopted.

No inference would be intended regarding the treatment of such transactions under present law.

VI. SOCIAL SECURITY PROVISIONS

A. Increases in the Social Security Earnings Limit for Individuals Who Have Attained Retirement Age

Present law

Senior citizens age 70 and older receive full Social Security benefits regardless of the amount of earnings they have from wages or self employment. Those between the full retirement age (currently age 65) and age 70 receive full benefits only if their earnings are lower than an earnings limit amount determined by law. In 1998, the limit for those age 65 to 69 is $14,500. The limit is gradually raised to $30,000 by the year 2002. After 2002, the annual exempt amounts are indexed to growth in average wages.

Year	Present Law
1998	$14,500
1999	$15,500
2000	$17,000
2001	$25,000
2002	$30,000

Senior citizens between the age of full retirement (currently age 65) and 70 who earn more than the earnings limit lose $1 in benefits for every $3 in wages or self-employment income they earn over the limit.

Description of Proposal

The proposal would raise the earnings limit for those between full retirement age (currently age 65) and age 70 in calendar years 1999 - 2001, as follows:

Year	Proposed earnings limit
1998	$14,500
1999	$17,000
2000	$18,500
2001	$26,000
2002	$30,000

Senior citizens between full retirement age (currently age 65) and 70 who earn over the given earnings limit for the year would continue to lose $1 in benefits for every $3 earned over the limit. After 2002, the annual exempt amounts would be indexed to growth in average wages.

The proposal would be effective for the taxable years ending after 1998.

B. Recomputations of Benefits after Normal Retirement Age

Present law

Social Security benefits are based on the average of an individual's "high" years of earnings. For workers born in 1929 or later, 35 "high" years of earnings are averaged. For those born before 1929, the number of "high" years averaged is proportionately fewer (for example, for those born in 1919, 25 "high" years are averaged).

If a retiree continues to work after entitlement to benefits, his or her monthly benefit may be increased if the new yearly earnings are greater than one of the years used in the initial determination of benefits. Currently, recomputations of benefits are effective in the year immediately following the year of the earnings. However, because of the lag between when wages are earned and when they are reported and recomputations are processed, most recomputations are actually paid in a lump-sum payment near the end of the year that they are effective. Subsequently, the adjustment is reflected in the new regular monthly benefit amount.

Description of Proposal

Recomputation of benefits resulting from earnings in the year after a worker reaches normal retirement age (currently age 65) and later would be reflected in the recipient's benefit check, effective with the January of the second year after the year of the earnings. An exception would be provided for recipients who have one or more "zero" years of earnings in their wage averaging computation. Earnings would continue to be credited as under current law for purposes of establishing entitlement.

Effective Date

The proposal would be effective for earnings beginning in 1998.