DESCRIPTION OF CHAIRMAN'S MARK
OF THE SMALL BUSINESS JOB PROTECTION ACT

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HOUSE COMMITTEE ON WAYS AND MEANS

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CONTENTS

	Page
INTRODUCTION	1
I. SMALL BUSINESS AND OTHER TAX PROVISIONS	2
A. Small Business Provisions	2
1. Increase in expensing for small businesses	2
2. Tax credit for Social Security taxes paid with respect to employee cash tips	3
B. Extension of Certain Expiring Provisions	4
1. Work opportunity tax credit	4
2. Employer-provided educational assistance	5
3. Permanent extension of FUTA exemption for alien agricultural workers	7
C. Provisions Relating to S Corporations	8
1. S corporations permitted to have 75 shareholders	8
2. Electing small business trusts	8
3. Expansion of post-death qualification for certain trusts	10
4. Financial institutions permitted to hold safe harbor debt	10
5. Rules relating to inadvertent terminations and invalid elections	11
6. Agreement to terminate year	12
7. Expansion of post-termination transition period	12
8. S corporations permitted to hold subsidiaries	13
9. Treatment of distributions during loss years	14
10. Treatment of S corporations under subchapter C	15
11. Elimination of certain earnings and profits	16
12. Carryover of disallowed losses and deductions under the at-risk rules	17
13. Adjustments to basis of inherited S stock to reflect certain items of income	18
14. S corporations eligible for rules applicable to real property subdivided for sale by noncorporate taxpayers	18
15. Reelecting subchapter S status	19

Page

II. PENSION SIMPLIFICATION PROVISIONS; FOREIGN SIMPLIFICATION 20

A. Simplified Distribution Rules 20

B. Increased Access to Pension Plans 24

1. Establish SIMPLE retirement plans 24
2. State and local governments and tax-exempt organizations eligible under section 401(k) 29

C. Nondiscrimination Provisions 30

1. Definition of highly compensated employees and repeal of family aggregation rules 30
2. Modification of additional participation requirements 31
3. Nondiscrimination rules for qualified cash or deferred arrangements and matching contributions 32
4. Definition of compensation for purposes of the limits on contributions and benefits 35

D. Miscellaneous Pension Simplification 36

1. Plans covering self-employed individuals 36
2. Elimination of special vesting rule for multiemployer plans 36
3. Distributions under rural cooperative plans 37
4. Treatment of governmental plans under section 415 37
5. Uniform retirement age 38
6. Contributions on behalf of disabled employees 39
7. Treatment of deferred compensation plans of State and local governments and tax-exempt organizations 39
8. Trust requirement for deferred compensation plans of State and local governments 40
9. Correction of GATT interest and morality rate provisions in the Retirement Protection Act 41
10. Multiple salary reduction agreements permitted under section 403(b) 42
11. Application of elective deferral limit to section 403(b) contracts 43

Page

12. Treatment of Indian tribal governments under section 403(b) 43
13. Waiver of minimum waiting period for qualified plan distributions 44
14. Repeal of combined plan limit 45
15. Tax on prohibited transactions 45
16. Treatment of leased employees 46
17. Uniform penalty provisions to apply to certain pension reporting requirements 48
18. Retirement benefits of ministers not subject to tax on net earnings from self-employment 49
19. Date for adoption of plan amendments 49

E. Foreign Simplification Provision 50

1. Repeal of excess passive assets provision 50

III. REVENUE OFFSETS 51

1. Phased-in repeal of Puerto Rico and possession tax credit 51
2. Repeal 50-percent interest income exclusion for financial institution loans to ESOPs 55
3. Apply look-through rule for purposes of characterizing certain subpart F insurance income as unrelated business taxable income 56
4. Depreciation under the income forecast method 58
5. Modify exclusion of damages received on account of personal injury or sickness 60
6. Repeal advance refunds of diesel fuel tax for purchasers of diesel-powered automobiles, vans, and light trucks 63

IV. TECHNICAL CORRECTIONS PROVISIONS 64

A. Technical Corrections to the Revenue Reconciliation Act of 1990 64

B. Technical Corrections to the Revenue Reconciliation Act of 1993 68

C. Other Tax Technical Corrections 71

D. Additional Tax Technical Corrections 75

E. Interaction Between Passive Activity Loss Rules and Earnings Stripping Rules 76

Page

F. Definition of Passive Income in Determining Passive Foreign Investment Company Status 78

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's proposed mark for a bill to be introduced on May 14, 1996, entitled the "Small Business Job Protection Act." The House Committee on Ways and Means has scheduled a markup of the Small Business Job Protection Act on that date.

Part I is a description of small business-related tax provisions; Part II is a description of pension simplification provisions and a foreign simplification provision; Part III is a description of revenue offsets; and Part IV is a description of technical corrections provisions.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Mark of the Small Business Job Protection Act* (JCX-21-96), May 13, 1996.

I. SMALL BUSINESS AND OTHER TAX PROVISIONS

A. Small Business Provisions

1. Increase in expensing for small businesses

Present Law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $17,500 of the cost of qualifying property placed in service for the taxable year (sec. 179).[2] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $17,500 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Description of Bill

The bill would increase the $17,500 amount allowed to be expensed under Code section 179 to $25,000. The increase would be phased in as follows:

Taxable year beginning in--	*Maximum expensing*
1996	$18,500
1997	$19,000
1998	$20,000
1999	$21,000
2000	$22,000
2001	$23,000
2002	$23,500
2003 and thereafter	$25,000

Effective Date

The provision would be effective for property placed in service in taxable years beginning after December 31, 1995, subject to the phase-in schedule set forth above.

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

2. Tax credit for Social Security taxes paid with respect to employee cash tips

Present Law

Employee tip income is treated as employer-provided wages for purposes of the Federal Insurance Contributions Act ("FICA"). Employees are required to report to the employer the amount of tips received. The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") provided a business tax credit with respect to certain employer FICA taxes paid with respect to tips treated as paid by the employer. The credit applies to tips received from customers in connection with the provision of food or beverages for consumption on the premises of an establishment with respect to which the tipping of employees is customary. OBRA 1993 provided that the FICA tip credit is effective for taxes paid after December 31, 1993. Temporary Treasury regulations provide that the tax credit is available only with respect to tips reported by the employee. The temporary regulations also provide that the credit is effective for FICA taxes paid by an employer after December 31, 1993, with respect to tips received for services performed after December 31, 1993.

Description of Bill

The bill would clarify the credit with respect to employer FICA taxes paid on tips by providing that the credit is available whether or not the employee reported the tips and that the credit is effective with respect to taxes paid after December 31, 1993, regardless of when the services with respect to which the tips are received were performed.

The bill also would modify the credit so that it applies with respect to tips received from customers in connection with the provision of food or beverages, regardless of whether the food or beverages are for consumption on the premises of the establishment.

Effective Date

The clarifications relating to the effective date and nonreported tips would be effective as if included in OBRA 1993. The provision expanding the tip credit to the provision of food or beverages not for consumption on the premises of the establishment would be effective with respect to FICA taxes paid on tips received with respect to services performed after December 31, 1996.

B. Extension of Certain Expiring Provisions

1. Work opportunity tax credit

Present Law

General rules.--Prior to January 1, 1995, the targeted jobs tax credit was available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The credit generally was equal to 40 percent of qualified first-year wages. Qualified first-year wages with respect to any individual could not exceed $6,000.

Certification of members of targeted groups.--In general, an individual was not treated as a member of a targeted group unless certification that the individual was a member of such a group was received or requested in writing by the employer from the designated local agency on or before the day on which the individual began work for the employer.

Targeted groups eligible for the credit.--The nine groups eligible for the credit were either recipients of payments under means-tested transfer programs, economically disadvantaged (as measured by family income), or disabled individuals:

(1) Vocational rehabilitation referrals;
(2) Economically disadvantaged youths;
(3) Economically disadvantaged former convicts;
(4) Economically disadvantaged summer youth employees;
(5) Aid to Families with Dependent Children ("AFDC") recipients;
(6) Economically disadvantaged Vietnam-era veterans;
(7) Economically disadvantaged cooperative education students;
(8) SSI recipients; and
(9) General assistance recipients.

Other rules.--No credit was available for wages paid to replacement employees during strikes or lockouts.

Minimum employment period.--No credit was allowed for wages paid unless the eligible individual was either (1) employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees) or (2) had completed at least 120 hours (20 hours for summer youth) of services performed for the employer.

Length of extension.--Expired January 1, 1995.

Description of Bill

General rules.--The bill would replace the targeted jobs tax credit with the "work opportunity tax credit." The work opportunity tax credit would be available on an elective basis

for employers hiring individuals from one or more of six targeted groups. The credit generally would equal to 35 percent of qualified wages.

Certification of members of targeted groups.--In general, an individual would not 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 pre-screening notice is completed with respect to that individual and within 14 days after the individual begins work for the employer, the employer submits such notice to the designated local agency as part of a written request for certification. The pre-screening notice would contain the information provided to the employer by the individual that forms the basis of the employer's belief that the individual was a member of a targeted group.

Targeted groups eligible for the credit.--There would be six groups eligible for the credit:

(1) Vocational rehabilitation referral;
(2) High-risk youth;
(3) Qualified ex-felon;
(4) Qualified summer youth employee;
(5) AFDC or successor program (with special rules for qualified veterans); and
(6) Qualified veterans

Other rules.--The bill would retain the prior-law rule denying the credit in the case of strikes or lockouts.

Minimum employment period.--No credit would be allowed for wages paid unless the eligible individual was employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 500 hours (120 hours in the case of a qualified summer youth employee).

Length of extension.--July 1, 1996, through June 30, 1997 (one year).

Effective Date

The credit would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1996, and before July 1, 1997.

2. Employer-provided educational assistance

Present Law

For taxable years beginning before January 1, 1995, an employee's gross income and wages did not include amounts paid or incurred by the employer for educational assistance

provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements. This exclusion, which expired for taxable years beginning after December 31, 1994, was limited to $5,250 of educational assistance with respect to an individual during a calendar year. The exclusion applied whether or not the education was job related. In the absence of this exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

Description of Bill

The bill would extend the exclusion for employer-provided educational assistance to taxable years beginning after December 31, 1994, and before January 1, 1998. In years beginning after December 31, 1995, the exclusion would not apply with respect to graduate-level courses.

To the extent employers have previously filed Forms W-2 reporting the amount of educational assistance provided as taxable wages, present Treasury regulations would require the employer to file Forms W-2c (i.e., corrected Forms W-2) with the Internal Revenue Service.[3] It would be intended that employers would also be required to provide copies of Form W-2c to affected employees.

The bill would provide that the Secretary shall establish expedited procedures for the refund of any overpayment of employment taxes paid on educational assistance provided in 1995 and 1996, including procedures for waiving the requirement that an employer obtain an employee's signature if the employer demonstrates to the satisfaction of the Secretary that any refund collected by the employer on behalf of the employee will be paid to the employee.

If an employer failed to withhold income and employment taxes on educational assistance provided before the date of enactment or failed to report such educational assistance, any penalties or interest on such failures would be waived. Further, it would be intended that the Secretary establish expedited procedures for refunding any interest and penalties relating to educational assistance previously paid.

Effective Date

The provision would be effective with respect to taxable years beginning after December 31, 1994, and before January 1, 1998, and the restriction of the exclusion to undergraduate education would be effective for taxable years beginning after December 31, 1995.

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[3] Treasury regulation section 31.6051-1(c).

3. Permanent extension of FUTA exemption for alien agricultural workers

Present Law

Generally, the Federal Unemployment Tax ("FUTA") is imposed on farm operators who (1) employ 10 or more agricultural workers for some portion of each of 20 different days, each day being in a different calendar week or (2) have a quarterly payroll for agricultural services of at least $20,000. An exclusion from FUTA was provided, however, for labor performed by an alien admitted to the United States to perform agricultural labor under section 214(c) and 101(a)(15)(H) of the Immigration and Nationality Act. This exclusion was effective for labor performed before January 1, 1995.

Description of Bill

The bill would permanently extend the FUTA exemption for alien agricultural workers.

Effective Date

The provision would be effective for labor performed on or after January 1, 1995.

C. Provisions Relating to S Corporations

1. S corporations permitted to have 75 shareholders

Present Law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders, (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual, (3) a nonresident alien as a shareholder, and (4) more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder.

Description of Bill

The bill would increase maximum number of eligible shareholders from 35 to 75.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

2. Electing small business trusts

Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may not be shareholders in a S corporation. A "qualified subchapter S trust" is a trust which, under its terms, (1) is required to have only one current income beneficiary (for life), (2) any corpus distributed during the life of the beneficiary must be distributed to the beneficiary, (3) the beneficiary's income interest must terminate at the earlier of the beneficiary's death or the termination of the trust, and (4) if the trust terminates during the beneficiary's life, the trust assets must be distributed to the beneficiary. All the income (as defined for local law purposes) must be currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation.

Description of Bill

In general

The bill would allow stock in an S corporation to be held by certain trusts ("electing small business trusts"). In order to qualify for this treatment, all beneficiaries of the trust must

be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. A trust must elect to be treated as an electing small business trust.

Each potential current beneficiary of the trust would be counted as a shareholder for purposes of the proposed 75 shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust.

Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations would be treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust is taxed at the highest individual rate (currently, 39.6 percent on ordinary income and 28 percent on net capital gain) on this portion of the trust's income. The taxable income attributable to this portion would include (1) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses are allowed only to the extent of capital gains.

In computing the trust's income tax on this portion of the trust, no deduction would be allowed for amounts distributed to beneficiaries, and no deduction or credit is allowed for any item other than the items described above. This income would not be included in the distributable net income of the trust, and thus is not included in the beneficiaries' income. No item relating to the S corporation stock could be apportioned to any beneficiary.

On the termination of all or any portion of an electing small business trust the loss carryovers or excess deductions referred to in section 642(h) would be taken into account by the entire trust, subject to the usual rules on termination of the entire trust.

Treatment of remainder of items held by trust

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust would be disregarded. Although distributions from the trust are deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J, the trust's distributable net income would not include any income attributable to the S corporation stock.

Termination of trust and conforming amendment applicable to all trusts

Where the trust terminates before the end of the S corporation's taxable year, the trust takes into account its pro rata share of S corporation items for its final year. The bill would make a conforming amendment applicable to all trusts and estates clarifying that this is the present-law treatment of trusts and estates that terminate before the end of the S corporation's taxable year.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

3. Expansion of post-death qualification for certain trusts

Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may not be shareholders in a S corporation. A grantor trust may remain an S corporation shareholder for 60 days after the death of the grantor. The 60-day period is extended to two years if the entire corpus of the trust is includible in the gross estate of the deemed owner. In addition, a trust may be an S corporation shareholder for 60 days after the transfer of S corporation pursuant to a will.

Description of Bill

The bill would expand the post-death holding period to two years for all testamentary trusts.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

4. Financial institutions permitted to hold safe harbor debt

Present Law

A small business corporation eligible to be an S corporation may not have more than one class of stock. Certain debt ("straight debt") is not treated as a second class of stock so long as such debt is an unconditional promise to pay on demand or on a specified date a sum certain in money if: (1) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; (2) there is no convertibility (directly or indirectly) into stock, and (3) the creditor is an individual (other than a nonresident alien), an estate, or certain qualified trusts.

Description of Bill

The definition of "straight debt" would be expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

5. Rules relating to inadvertent terminations and invalid elections

Present Law

Under present law, if the Internal Revenue Service ("IRS") determines that a corporation's Subchapter S election is inadvertently terminated, the IRS can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Present law does not grant the IRS the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The IRS may not validate a late election.

Description of Bill

Under the bill, the authority of the IRS to waive the effect of an inadvertent termination would be extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both. The bill would also allow the IRS to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely. The IRS may exercise this authority in cases where the taxpayer never filed an election. It is intended that the IRS be reasonable in exercising its authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations and other late or invalid elections.

Effective Date

The provision would apply to taxable years beginning after December 31, 1982.

6. Agreement to terminate year

Present Law

In general, each item of S corporation income, deduction and loss is allocated to shareholders on a per-share, per-day basis. However, if any shareholder terminates his or her interest in an S corporation during a taxable year, the S corporation, with the consent of all its shareholders, may elect to allocate S corporation items by closing its books as of the date of such termination rather than apply the per-share, per-day rule.

Description of Bill

The bill would provide that, under regulations to be prescribed by the Secretary of the Treasury, the election to close the books of the S corporation upon the termination of a shareholder's interest is made by all affected shareholders and the corporation, rather than by all shareholders. The closing of the books would apply only to the affected shareholders. For this purpose, "affected shareholders" means any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, "affected shareholders" includes all persons who were shareholders during the year.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

7. Expansion of post-termination transition period

Present Law

Distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distributions were made by an S corporation (e.g., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination period are generally treated as made by a C corporation (i.e., treated by shareholders as taxable dividends to the extent of earnings and profits).

The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, the audit procedures adopted by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") with respect to partnerships also apply to S corporations. Thus, the tax

treatment of items is determined at the corporate, rather than individual level.

Description of Bill

The present-law definition of post-termination period would be expanded to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of "determination" would be expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

In addition, the bill would repeal the TEFRA audit provisions applicable to S corporations and would provide other rules to require consistency between the returns of the S corporation and its shareholders.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

8. S corporations permitted to hold subsidiaries

Present Law

A small business corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation may not own 80 percent or more of the stock of another corporation (whether an S corporation or a C corporation).

In addition, a small business corporation may not have as a shareholder another corporation (whether an S corporation or a C corporation).

Description of Bill

An S corporation would be allowed to own 80 percent or more of the stock of a C corporation. The C corporation subsidiary could elect to join in the filing of a consolidated return with its affiliated C corporations. An S corporation would not be allowed to join in such election. Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake would be treated as passive investment income for purposes of sections 1362 and 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

In addition, an S corporation would be allowed to own a qualified subchapter S subsidiary. The term "qualified subchapter S subsidiary" means a domestic corporation that is

not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if (1) 100 percent of the stock of the subsidiary were held by its S corporation parent and (2) for which the parent elects to treat as a qualified subchapter S subsidiary. Under the election, the qualified subchapter S subsidiary would not be treated as a separate corporation and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

9. Treatment of distributions during loss years

Present Law

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of property.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.

In addition, if the S corporation has accumulated earnings and profits, any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

Description of Bill

The bill would provide that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year would reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year would not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The bill would also provide that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

10. Treatment of S corporations under subchapter C

Present Law

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). In 1988, the Internal Revenue Service took the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.[4] In 1992, the Internal Revenue Service reversed its position, stating that the prior

[4] PLR 8818049, (Feb. 10, 1988).

ruling was incorrect.[5]

Description of Bill

The bill would repeal the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the bill would clarify that the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation also would be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule would not change the general rule governing the computation of income of an S corporation. For example, it would not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

11. Elimination of certain earnings and profits

Present Law

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. As a result of this rule, a shareholder may later be required to include in his or her income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

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[5] PLR 9245004, (July 28, 1992).

Description of Bill

The bill would provide that if a corporation is an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of that year is reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits would be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his or her share of the taxable income of the S corporation.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

12. Carryover of disallowed losses and deductions under the at-risk rules

Present Law

Under section 1366, the amount of loss an S corporation shareholder may take into account cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the unadjusted basis in any indebtedness of the corporation to the shareholder. Any disallowed loss is carried forward to the next taxable year. Any loss that is disallowed for the last taxable year of the S corporation may be carried forward to the post-termination period. The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, under section 465, a shareholder of an S corporation may not deduct losses that are flowed through from the corporation to the extent the shareholder is not "at-risk" with respect to the loss. Any loss not deductible in one taxable year because of the at-risk rules is carried forward to the next taxable year.

Description of Bill

Losses of an S corporation that are suspended under the at-risk rules of section 465 would be carried forward to the S corporation's post-termination period.

Effective Date

The provision would apply to taxable years beginning after December 31, 1996.

13. Adjustments to basis of inherited S stock to reflect certain items of income

Present Law

Income in respect to a decedent ("IRD") generally consists of items of gross income that accrued during the decedent's lifetime but were not includible in the decedent's income before his or her death under his or her method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for the estate tax attributable to an item of IRD is allowed to such person (sec. 691(c)). The cost or basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis is often referred to as a "stepped-up basis." Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD (Treas. reg. sec. 1.742-1). This rule insures that the items of IRD held by a partnership are not later offset by a loss arising from a stepped-up basis. Although S corporation income is taxed to its shareholders in a manner similar to the taxation of a partnership and its partners, no comparable regulation requires a reduction in the basis of stock in an S corporation acquired from a decedent where the S corporation holds items of IRD.

Description of Bill

The bill would provide that a person acquiring stock in an S corporation from a decedent would treat as IRD his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. Where an item is treated as IRD, a deduction for the estate tax attributable to the item generally would be allowed under the provisions of section 691(c). The stepped-up basis in the stock in an S corporation acquired from a decedent is reduced by the extent to which the value of the stock would be attributable to items consisting of IRD. This basis rule would be comparable to the present-law partnership rule.

Effective Date

The provision would apply with respect to decedents dying after the date of enactment.

14. S corporations eligible for rules applicable to real property subdivided for sale by noncorporate taxpayers

Present Law

Under present-law section 1237, a lot or parcel of land held by a taxpayer other than a corporation generally is not treated as ordinary income property solely by reason of the land

being subdivided if: (1) such parcel had not previously been held as ordinary income property and if in the year of sale, the taxpayer did not hold other real property; (2) no substantial improvement has been made on the land by the taxpayer, a related party, a lessee, or a government; and (3) the land has been held by the taxpayer for five years.

Description of Bill

The bill would allow the present-law capital gains presumption in the case of land held by an S corporation. It is expected that rules similar to the attribution rules for partnerships would apply to S corporation (Treas. reg. sec. 1.1237-1(b)(3)).

Effective Date

The provision would be effective for sales in taxable years beginning after December 31, 1996.

15. Reelecting subchapter S status

Present Law

A small business corporation that terminates its subchapter S election (whether by revocation or otherwise) may not make another election to be an S corporation for five taxable years unless the Secretary of the Treasury consents to such election.

Description of Bill

For purposes of the five-year rule, any termination of subchapter S status in effect immediately before the date of enactment of the bill would not be taken into account. Thus, any small business corporation that had terminated its S corporation election within the five-year period before the date of enactment could re-elect subchapter S status upon enactment of the bill without the consent of the Secretary of the Treasury.

Effective Date

The provision would be effective for terminations occurring in a taxable year beginning before January 1, 1997.

II. PENSION SIMPLIFICATION PROVISIONS; FOREIGN SIMPLIFICATION

A. Simplified Distribution Rules

Present Law

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

Lump-sum distributions

Lump-sum distributions from qualified plans and annuities are eligible for special 5-year forward averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient first, on account of the death of the employee, second, after the employee attains age 59-1/2, third, on account of the employee's separation from service, or fourth, in the case of self-employed individuals, on account of disability. Lump-sum treatment is not available for distributions from a tax-sheltered annuity.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59-1/2 to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. In general, this election allows the taxpayer to pay a separate tax on the lump-sum distribution that approximates the tax that would be due if the lump-sum distribution were received in 5 equal installments. If the election is made, the taxpayer is entitled to deduct the amount of the lump-sum distribution from gross income. Only one such election on or after age 59-1/2 may be made with respect to any employee.

$5,000 exclusion for employer-provided death benefits

Under present law, the beneficiary or estate of a deceased employee generally can exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employee's death (sec. 101(b)).

Recovery of basis

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

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

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

Required distributions

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

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed beginning no later than the participant's required beginning date (sec. 401(a)(9)). The required beginning date is generally April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70-1/2. In the case of a governmental plan or a church plan, the required beginning date is the later of first, such April 1, or second, the April 1 of the year following the year in which the participant retires.

Description of Bill

Lump-sum distributions

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

$5,000 exclusion for employer-provided death benefits

The bill would repeal the $5,000 exclusion for employer-provided death benefits.

Recovery of basis

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

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

Required distributions

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

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70-1/2, the bill generally would require the employee's accrued benefit to be actuarially increased to take into account the period after age 70-1/2 in which the employee was not receiving benefits under the plan. Thus, under the bill, the employee's accrued benefit would be required to reflect the value of benefits that the employee would have received if the employee had retired at age 70-1/2 and had begun receiving benefits at that time.

The actuarial adjustment rule and the rule requiring 5-percent owners to begin distributions after attainment of age 70-1/2 would not apply, under the bill, in the case of a governmental plan or church plan.

Effective Date

Lump-sum distributions

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

$5,000 exclusion for employer-provided death benefits

The provision would apply with respect to decedents dying after date of enactment.

Recovery of basis

The provision would be effective with respect to annuity starting dates beginning 90 days after the date of enactment.

Required distributions

The provision would be effective for years beginning after December 31, 1996. Under the bill, it is intended that a plan (or an annuity contract) could permit, but would not be required to permit participants who have already begun to receive distributions but would not have to under the bill, to stop receiving distributions until such distributions are required under the bill.

B. Increased Access to Pension Plans

1. Establish SIMPLE retirement plans

Present Law

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

IRAs are not subject to the same rules as qualified plans, but the amount that can be contributed in any year is significantly less. The maximum deductible IRA contribution for a year is limited to $2,000. Distributions from IRAs and employer-sponsored retirement plans are generally taxable when made. In addition, distributions prior to age 59-1/2 generally are subject to an additional 10-percent early withdrawal tax.

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

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

Description of Bill

In general

The bill would create a simplified retirement plan for small business called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans could be adopted by employers who employ 100 or fewer employees on any day during the year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan could be either an IRA for each employee or part of a qualified cash or deferred arrangement ("401(k) plan"). If established in IRA form, a SIMPLE plan would not be subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements apply. Within limits, contributions to a SIMPLE plan would not be taxable until withdrawn.

A SIMPLE plan could also be adopted as part of a 401(k) plan. In that case, the plan would not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and would not be subject to the top-heavy rules. The other qualified plan rules would continue to apply.

SIMPLE retirement plans in IRA form

In general

A SIMPLE retirement plan would allow employees to make elective contributions to an IRA. Employee contributions would have to be expressed as a percentage of the employee's compensation, and could not exceed $6,000 per year. The $6,000 dollar limit would be indexed for inflation in $500 increments.

Under the bill, the employer would be required to satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally would be required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. Under a special rule, the employer could elect a lower percentage matching contribution for all employees (but not less than 1 percent of each employee's compensation). In order for the employer to lower the matching percentage for any year, the employer would have to notify employees of the applicable match within a reasonable time before the 30-day election period for the year (described below). In addition, a lower percentage could not be elected for more than 2 out of any 5 years.

Alternatively, for any year, an employer would be permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee with at least $5,000 in compensation for such year. If such an election were made, the employer would have to notify eligible employees of the change within a reasonable period before the 30-day election period for the year (described below). No contributions other than employee elective contributions and required employer matching

contributions (or, alternatively, required employer nonelective contributions) could be made to a SIMPLE account.

Only employers who employ 100 or fewer employees on any day during the year and who do not currently maintain a qualified plan could establish SIMPLE retirement accounts for their employees.

Each employee of the employer who received at least $5,000 in compensation from the employer during any 2 prior years and who is reasonably expected to receive at least $5,000 in compensation during the year would have to be eligible to participate in the SIMPLE plan. Nonresident aliens and employees covered under a collective bargaining agreement would not have to be eligible to participate in the SIMPLE plan. Self-employed individuals could participate in a SIMPLE plan.

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

Distributions from a SIMPLE plan generally would be taxed as under the rules relating to IRAs, except that an increased early withdrawal tax (25 percent) would apply to distributions within the first 2 years the employee first participates in the SIMPLE plan.

Tax treatment of SIMPLE accounts, contributions, and distributions

Contributions to a SIMPLE account generally would be deductible by the employer. In the case of matching contributions, the employer would be allowed a deduction for a year only if the contributions are made by the due date (including extensions) for the employer's tax return. Contributions to a SIMPLE account would be excludable from the employee's income. SIMPLE accounts, like IRAs, would not be subject to tax. Distributions from a SIMPLE retirement account generally would be taxed under the rules applicable to IRAs. Thus, they would be includible in income when withdrawn. Tax-free rollovers could be made from one SIMPLE account to another. A SIMPLE account could be rolled over to an IRA on a tax-free basis after a two-year period has expired since the individual first participated in the SIMPLE plan. To the extent an employee is no longer participating in a SIMPLE plan (e.g., the employee has terminated employment), the employee's SIMPLE account would be treated as an IRA.

Early withdrawals from a SIMPLE account generally would be subject to the 10-percent early withdrawal tax applicable to IRAs. However, withdrawals of contributions during the 2-year period beginning on the date the employee first participated in the SIMPLE plan would be subject to a 25-percent early withdrawal tax (rather than 10 percent).

Contributions to a SIMPLE account would not be subject to employment taxes or income tax withholding.

Administrative requirements

Each eligible employee could elect, within the 30-day period before the beginning of any year (or the 30-day period before first becoming eligible to participate), to participate in the SIMPLE plan (i.e., to make elective deferrals), and to modify any previous elections regarding the amount of contributions. An employer would be required to contribute employees' elective deferrals to the employee's SIMPLE account within 30 days after the end of the month to which the contributions relate. Employees would have to be allowed to terminate participation in the SIMPLE plan at any time during the year (i.e., to stop making contributions). The plan could provide that an employee who terminates participation could not resume participation until the following year. A plan could permit (but would not be required to permit) an individual to make other changes to his or her salary reduction contribution election during the year (e.g., reduce contributions). It would be intended that an employer would be permitted to designate a SIMPLE account trustee to which contributions on behalf of eligible employees are made.

Reporting requirements

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

Employer reports.--The employer maintaining a SIMPLE plan would be required to notify each employee of the employee's opportunity to make salary reduction contributions under the plan as well as the contribution alternative chosen by the employer immediately before the employee becomes eligible to make such election. This notice must include a copy of the summary description prepared by the trustee. An employer who fails to provide such notice would be subject to a penalty of $50 per day on which such failure continues, unless the failure is due to reasonable cause.

Definitions

For purposes of the rules relating to SIMPLE plans, compensation would be compensation required to be reported by the employer on Form W-2, plus any elective deferrals of the employee. In the case of a self-employed individual, compensation would be net earnings from self-employment. "Employer" would include the employer and related employers. Related employers would include trades or businesses under common control (whether incorporated or

not), controlled groups of corporations, and affiliated service groups. In addition, the leased employee rules would apply.

For purposes of the rule prohibiting an employer from establishing a SIMPLE plan, if the employer has another qualified plan, an employer would be treated as maintaining a qualified plan if the employer (or a predecessor employer) maintained a qualified plan with respect to which contributions were made, or benefits were accrued, with respect to service for any year in the period beginning with the year the SIMPLE plan became effective and ending with the year for which the determination is being made. A qualified plan would include a qualified retirement plan, a qualified annuity plan, a governmental plan, a tax-sheltered annuity, and a simplified employee pension.

SIMPLE 401(k) plans

In general, under the bill, a cash or deferred arrangement (i.e., 401(k) plan), would be deemed to satisfy the special nondiscrimination tests applicable to employee elective deferrals and employer matching contributions if the plan satisfies the contribution requirements applicable to SIMPLE plans. In addition, the plan would not be subject to the top-heavy rules for any year for which this safe harbor is satisfied. The plan would be subject to the other qualified plan rules.

The safe harbor would be satisfied if, for the year, the employer does not maintain another qualified plan and (1) employee's elective deferrals are limited to no more than $6,000, (2) the employer matches employees' elective deferrals up to 3 percent of compensation (or, alternatively, makes a 2 percent of compensation nonelective contribution on behalf of all eligible employees with at least $5,000 in compensation), and (3) no other contributions are made to the arrangement. Contributions under the safe harbor would have to be 100 percent vested. The employer could not reduce the matching percentage below 3 percent of compensation.

Repeal of SARSEPs

Under the bill, the present-law rules permitting SARSEPs would no longer apply after December 31, 1996, unless the SARSEP was established before January 1, 1997. Consequently, an employer would not be permitted to establish a SARSEP after December 31, 1996. SARSEPs established before January 1, 1997, could continue to receive contributions under present-law rules, and new employees of the employer hired after December 31, 1996, could participate in the SARSEP in accordance with such rules.

Effective Date

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

2. State and local governments and tax-exempt organizations eligible under section 401(k)

Present Law

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

Description of Bill

The bill would allow tax-exempt organizations (including, for this purpose, Indian tribal governments, a subdivision of an Indian tribal government, an agency or instrumentality of an Indian tribal government or subdivision thereof, or a corporation chartered under Federal, State, or tribal law which is owned in whole or in part by any of such entities) to maintain qualified cash or deferred arrangements. The bill would retain the present-law prohibition against the maintenance of cash or deferred arrangements by State and local governments, except to the extent it may apply to Indian tribes.

Effective Date

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

C. Nondiscrimination Provisions

1. Definition of highly compensated employees and repeal of family aggregation rules

Present Law

Definition of highly compensated employee

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

Family aggregation rules

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

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

Description of Bill

Definition of highly compensated employee

Under the bill, an employee would be treated as highly compensated if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year or (2) had compensation for the preceding year in excess of $80,000 (indexed for inflation) and the

employee was in the top 20 percent of employees by compensation for such year. The bill would also repeal the rule requiring the highest paid officer to be treated as a highly compensated employee.

Family aggregation rules

The bill would repeal the family aggregation rules.

Effective Date

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

2. Modification of additional participation requirements

Present Law

Under present law, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). This requirement may not be satisfied by aggregating comparable plans, but may be applied separately to different lines of business of the employer. A line of business of the employer does not qualify as a separate line of business unless it has at least 50 employees.

Description of Bill

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

The bill also would provide that the requirement that a line of business has at least 50 employees does not apply in determining whether a plan satisfies the minimum participation rule on a separate line of business basis.

Effective Date

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

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

Present Law

Under present law, a special nondiscrimination test applies to qualified cash or deferred arrangements (sec. 401(k) plans). The special nondiscrimination test is satisfied if the actual deferral percentage ("ADP") for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the ADP of all nonhighly compensated employees eligible to defer under the arrangement or (2) the lesser of 200 percent of the ADP of all eligible nonhighly compensated employees or such ADP plus 2 percentage points.

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

A plan that would otherwise fail to meet the special nondiscrimination test for qualified cash or deferred arrangements is not treated as failing such test if excess contributions (with allocable income) are distributed to the employee or, in accordance with Treasury regulations, recharacterized as after-tax employee contributions. For purposes of this rule, in determining the amount of excess contributions and the employees to whom they are allocated, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentage beginning with those highly compensated employees with the highest actual deferral percentages. A similar rule applies to employer matching contributions.

Description of Bill

Prior-year data

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

Alternatively, under the bill, an employer would be allowed to elect to use the current year actual deferral percentage (and actual contribution percentage). Such an election could be revoked only as provided by the Secretary.

Safe harbor for cash or deferred arrangements

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

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

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

Alternatively, if the rate of matching contribution with respect to any rate of elective contribution requirement is not equal to the percentages described in the preceding paragraph, the matching contribution requirement would be deemed to be satisfied if first, the rate of an employer's matching contribution does not increase as an employee's rate of elective contribution increase and second, the aggregate amount of matching contributions at such rate of elective contribution at least equals the aggregate amount of matching contributions that would be made if matching contributions satisfied the above percentage requirements. For example, the alternative test would be satisfied if an employer matches 125 percent of an employee's elective contributions up to the first 3 percent of compensation, 25 percent of elective deferrals from 3 to 4 percent of compensation, and provides no match thereafter. However, the alternative test would not be satisfied if an employer matches 80 percent of an employee's elective contributions up to the first 5 percent of compensation. The former example would satisfy the alternative test because the employer match does not increase and the aggregate amount of matching contributions at any rate of elective contribution is at least equal to the aggregate amount of matching contributions required under the general safe harbor rule.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules would be required to be nonforfeitable and subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)(2)(B) and (C)). It would be intended that employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules could be used to satisfy other qualified retirement plan nondiscrimination rules (except the special nondiscrimination test applicable to employer matching contributions (the

ACP test)). So, for example, a cross-tested defined contribution plan that includes a qualified cash or deferred arrangement could consider such employer matching and nonelective contributions in testing.[6]

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

<u>**Alternative method of satisfying special nondiscrimination test for matching contributions**</u>

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

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

Any after-tax employee contributions made under the qualified cash or deferred arrangement would continue to be tested under the ACP test. Employer matching and nonelective contributions used to satisfy the safe harbor rules for qualified cash or deferred arrangements could not be considered in calculating such test. However, employer matching and nonelective contributions in excess of the amount required to satisfy the safe harbor rules for qualified cash or deferred arrangements could be taken into account in calculating such test.

<u>**Distribution of excess contributions and excess aggregate contributions**</u>

The bill would provide that the total amount of excess contributions (and excess aggregate contributions) is determined as under present law, but the distribution of excess

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[6] It would be intended that if two plans which include qualified cash or deferred arrangements are treated as one plan for purposes of the nondiscrimination and coverage rules, such qualified cash or deferred arrangements would be treated as one qualified cash or deferred arrangement for purposes of the safe harbor rules. In such a case, unless both qualified cash or deferred arrangements satisfied the safe harbor, both qualified cash or deferred arrangements tested together would have to satisfy the ADP and ACP tests.

contributions (and excess aggregate contributions) would be required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, excess contributions (and excess aggregate contributions) would be deemed attributable first to those highly compensated employees who have the greatest dollar amount of elective deferrals.

Effective Date

The provisions relating to use of prior-year data and the distribution of excess contributions and excess aggregate contributions would be effective for years beginning after December 31, 1996. The provisions providing for a safe harbor for qualified cash or deferred arrangements and the alternative method of satisfying the special nondiscrimination test for matching contributions would be effective for years beginning after December 31, 1998.

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

Present Law

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

Description of Bill

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

Effective Date

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

D. Miscellaneous Pension Simplification

1. Plans covering self-employed individuals

Present Law

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

Description of Bill

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

Effective Date

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

2. Elimination of special vesting rule for multiemployer plans

Present Law

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

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

Description of Bill

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

Effective Date

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

3. Distributions under rural cooperative plans

Present Law

A qualified cash or deferred arrangement can permit withdrawals of employee elective deferrals only after the earlier of (1) the participant's separation from service, death, or disability, (2) termination of the arrangement, or (3) in the case of a profit-sharing or stock bonus plan, the attainment of age 59-1/2 or the occurrence of a hardship of the participant. In the case of a money purchase pension plan, including a rural cooperative plan, withdrawals by participants cannot occur upon attainment of age 59-1/2 or upon hardship.

Description of Bill

The bill would provide that a rural cooperative plan that includes a cash or deferred arrangement may permit distributions to plan participants after the attainment of age 59-1/2 or on account of hardship. In addition, the definition of a rural cooperative would be expanded to include certain public utility districts and a national association of rural cooperatives.

Effective Date

The provision would generally be effective for distributions after the date of enactment. The modifications to the definition of a rural cooperative would apply to plan years beginning after December 31, 1996.

4. Treatment of governmental plans under section 415

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan (sec. 415). Certain special rules apply to State and local governmental plans under which such plans may provide benefits greater than those permitted by the limits on benefits applicable to plans maintained by private employers.

In the case of defined benefit pension plans, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $120,000 (indexed for inflation). The dollar limit is reduced in the case of early retirement or if the employee has less than 10 years of plan participation.

Description of Bill

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

(1) the 100 percent of compensation limitation on defined benefit pension plan benefits would not apply; and

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

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

Effective Date

The provision would be effective for years beginning after December 31, 1994. No inference would be intended with respect to whether a governmental plan complies with the requirements of section 415 with respect to years beginning before January 1, 1995. With respect to such years, the Secretary would be directed to enforce the requirements of section 415 consistent with the provision.

5. Uniform retirement age

Present Law

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

Description of Bill

The bill would provide that for purposes of the general nondiscrimination rules (sec. 401(a)(4)) the Social Security retirement age (as defined in sec. 415) is a uniform retirement age

and that subsidized early retirement benefits and joint and survivor annuities are not treated as not being available to employees on the same terms merely because they are based on an employee's Social Security retirement age (as defined in sec. 415).

Effective Date

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

6. Contributions on behalf of disabled employees

Present Law

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

Description of Bill

The bill would provide that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

Effective Date

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

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

Present Law

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

Amounts deferred under a section 457 plan may not be made available to an employee before the earlier of (1) the calendar year in which the participant attains age 70-1/2, (2) when the participant is separated from the service with the employer, or (3) when the participant is faced with an unforeseeable emergency.

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

Description of Bill

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

The bill would: (1) permit in-service distributions of accounts that do not exceed $3,500 under certain circumstances; (2) increase the number of elections that can be made with respect to the time distributions must begin under the plan, and (3) provide for indexing (in $500 increments) of the dollar limit on deferrals.

Effective Date

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

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

Present Law

Until deferrals under a section 457 plan are made available to a plan participant, such amounts deferred, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights must remain solely the property and rights of the employer, subject only to the claims of the employer's general creditors.

Description of Bill

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

Effective Date

The provision generally would be effective with respect to amounts held on or after the date of enactment. In the case of amounts deferred before the date of enactment, a trust would not need to be established by reason of this provision until January 1, 1999.

9. Correction of GATT interest and mortality rate provisions in the Retirement Protection Act

Present Law

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

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

GATT made similar changes to the interest rate and mortality assumptions used to calculate the value of lump-sum distributions for purposes of the rule permitting involuntary dispositions of certain accrued benefits. In the case of a plan adopted and in effect before December 8, 1995, those provisions do not apply before the earlier of (1) the date a plan amendment applying the new assumption is adopted or made effective (whichever is later), or (2) the first day of the first plan year beginning after December 31, 1999.

Description of Bill

The bill would conform the effective date of the new interest rate and mortality assumptions that must be used under section 415 to calculate the limits on benefits and contributions to the effective date of the provision relating to the calculation of lump-sum distributions. This rule would apply only in the case of plans that were adopted and in effect before the date of enactment of GATT (December 8, 1994). To the extent plans have already been amended to reflect the new assumptions, plan sponsors would be permitted within 1 year of the date of enactment to amend the plan to reverse retroactively such amendment.[7]

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[7] It would be intended that plan sponsors would have flexibility in adopting the actuarial assumptions required under GATT. For example, plan sponsors would be permitted to apply the actuarial assumptions that must be used for 415 purposes retroactively as provided under GATT. Alternatively, plan sponsors could apply such actuarial assumptions prospectively by either (1) providing a benefit equal to (i) the accrued benefit as of the effective date of the adoption of the new actuarial assumptions determined after applying section 415 using the old actuarial assumptions, plus (ii) the benefit accrued after such effective date determined after applying section 415 using the new actuarial assumptions; or (2) providing a benefit equal to the greater of

The bill also would repeal the GATT provision which requires that if the benefit is payable before age 62 in a form subject to the requirements of section 417(e)(3) (e.g., lump sum), then the interest rate to be used to reduce the dollar limit on benefits under section 415 cannot be less than the greater of the rate on 30-year Treasury securities or the rate specified in the plan. Consequently, regardless of the form of benefit, the interest rate to be used could not be less than the greater of 5 percent or the rate specified in the plan.

Effective Date

The provision would be effective as if included in GATT.

10. Multiple salary reduction agreements permitted under section 403(b)

Present Law

Under Treasury regulations, a participant in a tax-sheltered annuity plan (sec. 403(b)) is not permitted to enter into more than one salary reduction agreement in any taxable year. These regulations further provide that a salary reduction agreement is effective only with respect to amounts "earned" after the agreement becomes effective, and that a salary reduction agreement must be irrevocable with respect to amounts earned while the agreement is in effect.

These restrictions do not apply to other elective deferral arrangements such as a qualified cash or deferred arrangement (sec. 401(k)). Under Treasury regulations, participants in a qualified cash or deferred arrangement may enter into more than one salary reduction agreement in a taxable year, such an agreement is effective with respect to compensation currently available to the participant after the agreement becomes effective even though previously "earned," and the agreement may be revoked by the participant.

Description of Bill

The bill would provide that for participants in a tax-sheltered annuity plan, the frequency that a salary reduction agreement may be entered into, the compensation to which such agreement applies, and the ability to revoke such agreement shall be determined under the rules applicable to qualified cash or deferred arrangements.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

(i) the accrued benefit as the effective date of the adoption of the new actuarial assumptions determined after applying section 415 using the old actuarial assumptions, or (ii) the entire accrued benefit determined after applying section 415 using the new actuarial assumptions.

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

Present Law

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

Description of Bill

Under the bill, each tax-sheltered annuity contract, not the tax-sheltered annuity plan, would have to provide that elective deferrals made under the contract may not exceed the annual limit on elective deferrals. It would be intended that the contract terms be given effect in order for this requirement to be satisfied. Thus, for example, if the annuity contract issuer takes no steps to ensure that deferrals under the contract do not exceed the applicable limit, then the contract would not be treated as satisfying section 403(b). The provision would be intended to make clear that the exclusion of elective deferrals from gross income by employees who have not exceeded the annual limit on elective deferrals will not be affected to the extent other employees exceed the annual limit. However, if the occurrence of an uncorrected elective deferral made by an employee is attributable to reasonable error, the contract would not fail to satisfy section 403(b), and only the portion of the elective deferral in excess of the annual limit would be includible in gross income.

Effective Date

The provision would be effective for years beginning after December 31, 1995, except that an annuity contract would not be required to meet any change in any requirement by reason of the provision before the 90th day after the date of enactment.

12. Treatment of Indian tribal governments under section 403(b)

Present Law

Under present law, certain tax-exempt employers and certain State and local government educational organizations are permitted to maintain tax-sheltered annuity plans (sec. 403(b)). Indian tribal governments are treated as States for this purpose, so certain educational organizations associated with a tribal government are eligible to maintain tax-sheltered annuity plans.

Description of Bill

The bill would provide that any 403(b) annuity contract purchased in a plan year beginning before January 1, 1995 by an Indian tribal government shall be treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. The bill also would provide

that such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government.

Effective Date

The provision would be effective on the date of enactment.

13. Waiver of minimum waiting period for qualified plan distributions

Present Law

Under present law, in the case of a qualified joint and survivor annuity, a written explanation of the form of benefit must generally be provided to participants no less than 30 days and no more than 90 days before the annuity starting day. Even if a participant has elected to waive the qualified joint and survivor annuity and the spouse has consented to the distribution, the distribution from the plan cannot be made until 30 days after the written explanation was provided to the participant.[8]

Description of Bill

The bill would provide that the minimum period between the date the explanation of the qualified joint and survivor annuity is provided and the annuity starting date does not apply if it is waived by the participant and, if applicable, the participant's spouse. For example, if the participant has not elected to waive the qualified joint and survivor annuity, only the participant would need to waive the minimum waiting period.

Effective Date

The provision would be effective with respect to plan years beginning after December 31, 1996.

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[8] On September 15,1995, Treasury issued temporary regulations (T.D. 8620) which provide that a plan may permit a participant to elect (with any applicable spousal consent) a distribution with an annuity starting date before 30 days have elapsed since the explanation was provided, as long as the distribution commences more than seven days after the explanation was provided. Consequently, even if the participant (and spouse, if applicable) has elected to waive the minimum waiting period for receiving a qualified plan distribution, the distribution from the plan cannot be made until seven days have elapsed since the explanation was provided to the participant.

14. Repeal of combined plan limit

Present Law

Combined plan limit

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

Excess distribution tax

Present law imposes a 15-percent excise tax on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. Excess distributions are generally the aggregate amount of retirement distributions from such plans during any calendar year in excess of $150,000 (or $750,000 in the case of a lump-sum distribution). An additional 15-percent estate tax is also imposed on an individual's excess retirement accumulation.

Description of Bill

Combined plan limit

The bill would repeal the combined plan limit.

Excess distribution tax

Until the repeal of the combined plan limit is effective, the bill would suspend the excise tax on excess distributions. The additional estate tax on excess accumulations would continue to apply.

Effective Date

The provision repealing the combined plan limit would be effective with respect to limitation years beginning after December 31, 1998. The provision relating to the excise tax on excess distributions would be effective with respect to distributions received in 1996, 1997, and 1998.

15. Tax on prohibited transactions

Present Law

Present law prohibits certain transactions (prohibited transactions) between a qualified pension plan and a disqualified person in order to prevent persons with a close relationship to the

qualified plan from using that relationship to the detriment of plan participants and beneficiaries. A two-tier excise tax is imposed on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction. If the transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed.

Description of Bill

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

Effective Date

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

16. Treatment of leased employees

Present Law

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

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

Description of Bill

Under the bill, the present-law "historically performed" test is replaced with a new test under which an individual is not considered a leased employee unless the individual's services are performed under primary direction or control by the service recipient. As under present law, the determination of whether someone is a leased employee is made after determining whether the individual is a common-law employee of the recipient. Thus, an individual who is not a common-law employee of the service recipient could nevertheless be a leased employee of the service recipient. Similarly, the fact that a person is or is not found to perform services under primary direction or control of the recipient for purposes of the employee leasing rules is not determinative of whether the person is or is not a common-law employee of the recipient.

Whether services are performed by an individual under primary direction or control by the service recipient depends on the facts and circumstances. In general, primary direction and control means that the service recipient exercises the majority of direction and control over the individual. Factors that are relevant in determining whether primary direction or control exists include whether the individual is required to comply with instructions of the service recipient about when, where, and how he or she is to perform the services, whether the services must be performed by a particular person, whether the individual is subject to the supervision of the service recipient, and whether the individual must perform services in the order or sequence set by the service recipient. Factors that generally are not relevant in determining whether such direction or control exists include whether the service recipient has the right to hire or fire the individual and whether the individual works for others.

For example, an individual who works under the direct supervision of the service recipient would be considered to be subject to primary direction or control of the service recipient even if another company hired and trained the individual, had the ultimate (but unexercised) legal right to control the individual, paid his wages, withheld his employment and income taxes, and had the exclusive right to fire him. Thus, for example, temporary secretaries, receptionists, word processing personnel and similar office personnel who are subject to the day-to-day control of the employer in essentially the same manner as a common law employee are treated as leased employees if the period of service threshold is reached.

On the other hand, an individual who is a common-law employee of Company A who performs services for Company B on the business premises of Company B under the supervision of Company A would generally not be considered to be under primary direction or control of Company B. The supervision by Company A must be more than nominal, however, and not merely a mechanism to avoid the literal language of the direction or control test.

An example of the situation in the preceding paragraph might be a work crew that comes into a factory to install, repair, maintain, or modify equipment or machinery at the factory. The work crew includes a supervisor who is an employee of the equipment (or equipment repair) company and who has the authority to direct and control the crew, and who actually does exercise such direction and control. In this situation, the supervisor and his or her crew are required to comply with the safety and environmental precautions of the manufacturer, and the supervisor is in frequent communication with the employees of the manufacturer. As another example, certain professionals (e.g., attorneys, accountants, actuaries, doctors, computer programmers, systems analysts, and engineers) who regularly make use of their own judgement and discretion on matters of importance in the performance of their services and are guided by professional, legal, or industry standards, are not leased employees even though the common law employer does not closely supervise the professional on a continuing basis, and the service recipient requires the services to be performed on site and according to certain stages, techniques, and timetables. In addition to the example above, outside professionals who maintain their own businesses (e.g., attorneys, accountants, actuaries, doctors, computer programmers, systems analysts, and engineers) generally would not be considered to be subject

to such primary direction or control.

Under the direction or control test, clerical and similar support staff (e.g., secretaries and nurses in a doctor's office) generally would be considered to be subject to primary direction or control of the service recipient and would be leased employees provided the other requirements of section 414(n) are met.

In many cases, the "historically performed" test is overly broad, and results in the unintended treatment of individuals as leased employees. One of the principal purposes for changing the leased employee rules is to relieve the unnecessary hardship and uncertainty created for employers in these circumstances. However, it is not intended that the direction or control test enable employers to engage in abusive practices. Thus, it is intended that the Secretary interpret and apply the leased employee rules in a manner so as to prevent abuses. This ability to prevent abuses under the leasing rules is in addition to the present-law authority of the Secretary under section 414(o). For example, one potentially abusive situation exists where the benefit arrangements of the service recipient overwhelmingly favor its highly compensated employees, the employer has no or very few nonhighly compensated common-law employees, yet the employer makes substantial use of the services of nonhighly compensated individuals who are not its common-law employees.

Effective Date

The provision would be effective for years beginning after December 31, 1996, except that the bill would not apply to relationships that have been previously determined by an IRS ruling not to involve leased employees. In applying the leased employee rules to years beginning before the effective date, it would be intended that the Secretary use a reasonable interpretation of the statute to apply the leasing rules to prevent abuse.

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

Present Law

Any person who fails to file an information report with the IRS on or before the prescribed filing date is subject to penalties for each failure. A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments.

Description of Bill

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

Effective Date

The provision would be effective with respect to returns and statements the due date for which is after December 31, 1996.

18. Retirement benefits of ministers not subject to tax on net earnings from self-employment

Present Law

Under present law, certain benefits provided to ministers after they retire are subject to self-employment tax.

Description of Bill

The bill would provide that retirement benefits received from a church plan after a minister retires, and the rental value of a parsonage (including utilities) furnished to a minister after retirement, are not subject to self-employment taxes.

Effective Date

The provision would be effective for years beginning before, on, or after December 31, 1994.

19. Date for adoption of plan amendments

Present Law

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

Description of Bill

The bill would generally provide that any amendments to a plan or annuity contract required by the pension simplification bills would not be required to be made before the first plan year beginning on or after January 1, 1997. The date for amendments would be extended to the first plan year beginning on or after January 1, 1999, in the case of a governmental plan.

Effective Date

The provision would be effective on the date of enactment.

F. Foreign Simplification Provision

1. Repeal of excess passive assets provision

Present Law

Under the rules of subpart F (secs. 951-964), certain 10-percent U.S. shareholders of a controlled foreign corporation (CFC) are required to include in income currently for U.S. tax purposes certain earnings of the CFC, whether or not such earnings are actually distributed currently to the shareholders. The 10-percent U.S. shareholders of a CFC are subject to current U.S. tax on their shares of certain income earned by the CFC (referred to as "subpart F income"). The 10-percent U.S. shareholders are also subject to current U.S. tax on their shares of the CFC's earnings to the extent such earnings are invested by the CFC in certain U.S. property.

In addition to these current inclusion rules, the Omnibus Budget Reconciliation Act of 1993 enacted section 956A, which applies another current inclusion rule to U.S. shareholders of a CFC. Section 956A requires the 10-percent U.S. shareholders of a CFC to include in income currently their shares of the CFC's earnings to the extent such earnings are invested by the CFC in excess passive assets. A CFC generally is treated as having excess passive assets if the average of the amounts of its passive assets exceeds 25 percent of the average of the amounts of its total assets; this calculation requires a quarterly determination of the CFC's passive assets and total assets.

Description of Bill

The bill would repeal section 956A.

Effective Date

The provision would apply to taxable years of U.S. shareholders beginning after December 31, 1996, and taxable years of foreign corporations ending with or within such taxable years of U.S. shareholders.

III. REVENUE OFFSETS

1. Phased-in repeal of Puerto Rico and possession tax credit

Present Law

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

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

A domestic corporation that has elected the Puerto Rico and possession tax credit and that satisfies these two conditions for a taxable year generally is entitled to a credit based on the U.S. income tax attributable to the sum of the taxpayer's possession business income and its QPSII. However, the amount of the credit attributable to possession business income is subject to the limitations enacted by the Omnibus Budget Reconciliation Act of 1993 ("1993 Act"). Under the economic activity limit, the amount of the credit with respect to such income cannot exceed the sum of a portion of the taxpayer's wage and fringe benefit expenses and depreciation allowances (plus, in certain cases, possession income taxes). In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage is phased down to 50 percent for 1996, 45 percent for 1997, and 40 percent for 1998 and thereafter. The amount of the Puerto Rico and possession tax credit attributable to QPSII is not subject to these limitations.

Description of Bill

The bill generally would repeal the Puerto Rico and possession tax credit for taxable years beginning after December 31, 1995. However, the bill would provide grandfather rules under which a corporation that is an existing credit claimant would be eligible to claim credits

for a transition period. A special transition rule would apply to the credit attributable to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands.

For taxable years beginning after December 31, 1995, the Puerto Rico and possession tax credit would apply only to a corporation that qualifies as an existing credit claimant (as defined below). A corporation that is an existing credit claimant would be subject to the limitations described below in determining the credit for taxable years beginning after December 31, 1995.

The Puerto Rico and possession tax credit attributable to QPSII would be eliminated for taxable years beginning after December 31, 1995. For taxable years beginning after December 31, 1995, the Puerto Rico and possession tax credit would be available only with respect to possession business income. The computation of the Puerto Rico and possession tax credit attributable to possession business income during the grandfather period would depend upon whether the corporation is using the economic activity limit or the applicable percentage limit.

For corporations that are existing credit claimants with respect to a possession and that use the economic activity limit, the Puerto Rico and possession tax credit attributable to business income from the possession (determined under the economic activity limit) would continue to be determined as under present law for taxable years beginning after December 31, 1995 and before January 1, 2002. For taxable years beginning after December 31, 2001 and before January 1, 2006, the corporation's possession business income that is eligible for the credit would be subject to a cap computed as described below. For taxable years beginning in 2006 and thereafter, the credit attributable to possession business income (determined under the economic activity limit) would be eliminated. The economic activity credit with respect to Puerto Rico, which would be computed under the foregoing rules, would be contained in a separate section of the Code.

For corporations that are existing credit claimants with respect to a possession and that elected to use the applicable percentage limit and not to use the economic activity limit, the Puerto Rico and possession tax credit attributable to business income from the possession would continue to be determined as under present law for taxable years beginning after December 31, 1995 and before January 1, 1998. For taxable years beginning after December 31, 1997 and before January 1, 2006, the corporation's possession business income that is eligible for the credit would be subject to a cap computed as described below. For taxable years beginning in 2006 and thereafter, the credit attributable to possession business income (determined under the applicable percentage limit) would be eliminated.

A corporation that had elected to use the applicable percentage limit is permitted to revoke that election under present law. Under the bill, such a revocation would be required to be made not later than with respect to the first taxable year beginning after December 31, 1996; such revocation, if made, would apply to such taxable year and to all subsequent taxable years. Accordingly, a corporation that had an election in effect to use the applicable percentage limit could revoke such election effective for its taxable year beginning in 1997 and thereafter; such corporation would continue to use the applicable percentage limit for its taxable year beginning in 1996 and would use the economic activity limit for its taxable year beginning in 1997 and

thereafter.

The cap on a corporation's possession business income that is eligible for the Puerto Rico and possession tax credit would be computed based on the corporation's possession business income for the base period years ("average adjusted base period possession business income"). Average adjusted base period possession business income would be the average of the adjusted possession business income for each of the corporation's base period years. For the purpose of this computation, the corporation's possession business income for a base period year would be adjusted by an inflation factor that reflects inflation from such year to 1995. In addition, as a proxy for real growth in income throughout the base period, the inflation factor would be increased by 5 percentage points compounded for each year from such year to the corporation's first taxable year beginning on or after October 14, 1995.

The corporation's base period years generally would be three of the corporation's five most recent years ending before October 14, 1995, determined by disregarding the taxable years in which the adjusted possession business incomes were highest and lowest. For purposes of this computation, only years in which the corporation had significant possession business income would be taken into account. A corporation would be considered to have significant possession business income for a taxable year if such income exceeds two percent of the corporation's possession business income for the each of the six taxable years ending with the first taxable year ending on or after October 14, 1995. If the corporation has significant possession business income for only four of the five most recent taxable years ending before October 14, 1995, the base period years would be determined by disregarding the year in which the corporation's possession business income was lowest. If the corporation has significant possession business income for three years or fewer of such five years, then the base period years would be all such years. If there is no year of such five taxable years in which the corporation has significant possession business income, then the corporation would be permitted to use as its base period its first taxable year ending on or after October 14, 1995; for this purpose, the amount of possession business income taken into account would be the annualized amount of such income for the portion of the year ended September 30, 1995.

As one alternative, the corporation would be permitted to use its taxable year ending in 1992 as its base period (with the adjusted possession business income for such year constituting its cap). As another alternative, the corporation would be permitted to use as its cap the annualized amount of its possession business income for the first ten months of calendar year 1995, calculated by excluding any extraordinary items (as determined under generally accepted accounting principles) for such period. For this purpose, it is intended that transactions with a related party that are not in the ordinary course of business would be considered to be extraordinary items.

If a corporation's possession business income in a year for which the cap is applicable exceeds the cap, then the corporation's possession business income for purposes of computing its Puerto Rico and possession tax credit for the year would be an amount equal to the cap. The corporation's credit would continue to be subject to either the economic activity limit or the

applicable percentage limit, with such limit applied to the corporation's possession business income as reduced to reflect the application of the cap.

A corporation would be an existing credit claimant with respect to a possession if (1) the corporation is engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation has elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which is in effect for its taxable year that includes October 13, 1995. A corporation that adds a substantial new line of business after October 13, 1995, would cease to be an existing credit claimant as of the beginning of the taxable year during which such new line of business is added.

For purposes of these rules, a corporation would be treated as engaged in the active conduct of a trade or business within a possession on October 13, 1995, if such corporation is engaged in the active conduct of such trade or business before January 1, 1996, and such corporation has in effect on October 13, 1995, a binding contract for the acquisition of assets to be used in, or the sale of property to be produced in, such trade or business. For example, if a corporation has in effect on October 13, 1995, binding contracts for the lease of a facility and the purchase of machinery to be used in a manufacturing business in a possession and if the corporation begins actively conducting that manufacturing business in the possession before January 1, 1996, that corporation would be an existing credit claimant. A change in the ownership of a corporation would not affect its status as an existing credit claimant.

In determining whether a corporation has added a substantial new line of business, it is intended that principles similar to those reflected in Treas. Reg. section 1.7704-2(d) (relating to the transition rules for existing publicly traded partnerships) would apply. For example, a corporation that modifies its current production methods, expands existing facilities, or adds new facilities to support the production of its current product lines and products within the same four-digit Industry Number Standard Industrial Classification Code (Industry SIC Code) would not be considered to have added a substantial new line of business. In this regard, it is intended that the fact that a business which is added is assigned a different four-digit Industry SIC Code than is assigned to an existing business of the corporation would not automatically cause the corporation to be considered to have added a new line of business. For example, a pharmaceutical corporation that begins manufacturing a new drug would not be considered to have added a new line of business. Moreover, a pharmaceutical corporation that begins to manufacture a complete product from the bulk active chemical through the finished dosage form, a process that may be assigned two separate four-digit Industry SIC Codes, would not be considered to have added a new line of business even though it was previously engaged in activities that involved only a portion of the entire manufacturing process from bulk chemicals to finished dosages.

A special transition rule would apply to the Puerto Rico and possession tax credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. Income attributable to operations in these possessions would not be taken into account in computing the income cap described above. A corporation would be considered to be an existing credit claimant with respect to one of these possessions if the corporation is an

existing credit claimant and is engaged in the active conduct of a trade or business within such possession on October 13, 1995 (or is treated as so engaged under the binding contract rule described above). For any taxable year beginning after December 31, 1995, a corporation that is not an existing credit claimant with respect to one of these possessions for such year would not be entitled to the Puerto Rico and possession tax credit with respect to operations in such possession. For any taxable year beginning after December 31, 1995, and before January 1, 2006, a corporation that is an existing credit claimant with respect to one of these possessions for such year would continue to determine its credit with respect to operations in such possession as under present law. For taxable years beginning in 2006 and thereafter, the Puerto Rico and possession tax credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands would be eliminated.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

2. Repeal 50-percent interest income exclusion for financial institution loans to ESOPs

Present Law

A bank, insurance company, regulated investment company, or a corporation actively engaged in the business of lending money may generally exclude from gross income 50 percent of interest received on an ESOP loan (sec. 133). The 50-percent interest exclusion only applies if: (1) immediately after the acquisition of securities with the loan proceeds, the ESOP owns more than 50 percent of the outstanding stock or more than 50 percent of the total value of all outstanding stock of the corporation; (2) the ESOP loan term will not exceed 15 years; and (3) the ESOP provides for full pass-through voting to participants on all allocated shares acquired or transferred in connection with the loan.

Description of Bill

The bill would repeal the 50-percent interest exclusion with respect to ESOP loans.

Effective Date

The provision would generally be effective with respect to loans made after October 13, 1995. The repeal of the 50-percent interest exclusion would not apply to the refinancing of an ESOP loan originally made on or before October 13, 1995, provided: (1) such refinancing loan otherwise meets the requirements of section 133 in effect on or before October 13, 1995; (2) the outstanding principal amount of the loan is not increased; and (3) the term of the refinancing loan does not extend beyond the term of the original ESOP loan.

3. Apply look-through rule for purposes of characterizing certain subpart F insurance income as unrelated business taxable income

Present Law

An organization that is exempt from tax by reason of Code section 501(a) (e.g., a charity, business league, or qualified pension trust) is nonetheless subject to tax on its unrelated business taxable income (UBTI) (sec. 511). Unrelated business taxable income generally excludes dividend income (sec. 512(b)(1)).

Special rules apply to a tax-exempt organization described in section 501(c)(3) or (c)(4) (i.e., a charity or social welfare organization) that is engaged in commercial-type insurance activities. Such activities are treated as an unrelated trade or business and the tax-exempt organization is subject to tax on the income from such insurance activities (including investment income that might otherwise be excluded from the definition of unrelated business taxable income) under subchapter L (sec. 501(m)(2)).[9] Accordingly, a tax-exempt organization described in section 501(c)(3) or (c)(4) generally is subject to tax on its income from commercial-type insurance activities in the same manner as a taxable insurance company.

A tax-exempt organization that conducts insurance activities through a foreign corporation is not subject to U.S. tax with respect to such activities. Under the subpart E rules, the United States shareholders (as defined in sec. 951(b)) of a controlled foreign corporation ("CFC") are required to include in income currently their shares of certain income of the CFC, whether or not such income is actually distributed to the shareholders. This current inclusion rule applies to certain insurance income of the CFC (sec. 953). However, income inclusions under subpart F have been characterized as dividends for unrelated business income tax purposes.[10] Accordingly, insurance income earned by the CFC that is includible in income

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[9] If the commercial-type insurance activities constitute a substantial part of the organization's activities, the organization will not be tax-exempt under section 501(c)(3) or (c)(4) (sec. 501(m)(1)).

[10] The Internal Revenue Service has concluded in private letter rulings, which are not to be used or cited as precedent, that subpart F inclusions are treated as dividends received by the United States shareholder (a tax-exempt entity) for purposes of computing the shareholder's UBTI (see LTRs 9407007 (November 12, 1993), 9027051 (April 13, 1990), 9024086 (March 22, 1990), 9024026 (March 15, 1990), 8922047 (March 6, 1989), 8836037 (June 14, 1988), 8819034 (February 10, 1988)). However, the IRS issued one private ruling in which it concluded that subpart F inclusions are treated as if the underlying income were realized directly by the United States shareholder (a tax-exempt entity) for purposes of computing the shareholder's UBTI (see LTR 9043039 (July 30, 1990)). This ruling gave no explanation for the IRS's departure from the position in its prior rulings, and the IRS reiterated in a subsequent ruling the position that subpart F inclusions are characterized as dividends for purposes of computing UBTI. Moreover, the

currently under subpart F by the taxable United States shareholders of the CFC is excluded from unrelated business taxable income in the case of a shareholder that is a tax-exempt organization.

Description of Bill

The bill would apply a look-through rule in characterizing certain subpart F insurance income for unrelated business income tax purposes. Under the bill, the look-through rule would apply to amounts that constitute insurance income currently includible in gross income under the subpart F rules and that are not attributable to the insurance of risks of (1) the tax-exempt organization itself, (2) certain tax-exempt affiliates of such organization, or (3) an officer or director of, or an individual who (directly or indirectly) performs services for, the tax-exempt organization (or certain tax-exempt affiliates) provided that the insurance covers primarily risks associated with the individual's performance of services in connection with the tax-exempt organization (or tax-exempt affiliates). An individual who performs services for a tax-exempt organization through a partnership, for example, would be indirectly performing services for such organization. It is intended that the determination of whether insurance covers primarily risks associated with the performance of services in connection with the tax-exempt organization or its tax-exempt affiliates would be based on all the facts and circumstances. It is further intended that a safe harbor be provided under which this "primarily" requirement would be considered to be satisfied where at least 80 percent of the services covered by the insurance are performed by the insured individual in connection with the tax-exempt organization or its tax-exempt affiliates. For purposes of determining whether the insurance covers risks associated with the individual's performance of services in connection with the tax-exempt organization, it is intended that the individual would not be considered to have performed services in connection with a tax-exempt organization solely by reason of the fact that the individual performs services at a facility leased to the individual by the tax-exempt organization.

For purposes of this bill, a tax-exempt organization would be an affiliate of another tax-exempt organization if (1) the two organizations have significant common purposes and substantial common membership or (2) the two organizations have directly or indirectly substantial common direction or control.

The specified exceptions from the look-through rule would apply on a shareholder by shareholder basis. Accordingly, if the subpart F insurance income allocable to a tax-exempt organization includes both income attributable to the insurance of risks of the organization itself and income attributable to the insurance of risks of another shareholder that is not a tax-exempt affiliate of such organization, the look-through rule would apply only to that portion of the

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application of the look-through rule in the ruling in question did not affect the ultimate result in the ruling because the income to which the subpart F inclusion was attributable was of a type that was excludible from UBTI. It is believed that LTR 9043039 (July 30, 1990) is incorrect in its application of a look-through rule in characterizing income inclusions under subpart F for unrelated business income tax purposes.

income that represents income attributable to the insurance of risks of such other shareholder (and would not apply to the portion of the income that represents income attributable to the insurance of risks of the organization itself). In this regard, it is intended that if the CFC serves as a vehicle for the separate funding by each shareholder of its risks or liabilities for claims, without any pooling of a shareholder's risks or liabilities for claims with those of another shareholder either directly or through reinsurance, allocations that fairly reflect such arrangement would be respected for purposes of applying the look-through rule.

Effective Date

The provision would apply to amounts includible in gross income in taxable years beginning after December 31, 1995.

4. Depreciation under the income forecast method

Present Law

Depreciation and amortization, in general

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

Treatment of film, video tape, and similar property

MACRS does not apply to certain property, including (1) any motion picture film, video tape, or sound recording or (2) any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. Likewise, section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property unless acquired as part of a trade or business. Thus, the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the general depreciation provision of section 167, which allows deductions for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property.

The "income forecast" method is an allowable method for calculating depreciation under

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

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

Description of Bill

The bill would make several amendments to the income forecast method of determining depreciation deductions.

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

episodes from the series, the forecasted income for the episodes of the first three years of the series need not take into account any future syndication fees (unless the taxpayer enters into an arrangement to syndicate such episodes during such period). The 10-year rule, the financial exploitation rule, and the syndication rule would apply for purposes of the look-back method described below.

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

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

Effective Date

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

5. Modify exclusion of damages received on account of personal injury or sickness

Present Law

Under present law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness (sec. 104(a)(2)).

The exclusion from gross income of damages received on account of personal injury or sickness specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Courts presently differ as to whether the exclusion applies to punitive damages received in connection with a case involving a physical injury or physical sickness.[11] Certain States provide that, in the case of claims under a wrongful death statute, only punitive damages may be awarded.

Courts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. The damages received in these cases generally consist of back pay and other awards intended to compensate the claimant for lost wages or lost profits. The Supreme Court recently held that damages received based on a claim under the Age Discrimination in Employment Act could not be excluded from income.[12] In light of the Supreme Court decision, the Internal Revenue Service has suspended existing guidance on the tax treatment of damages received on account of other forms of employment discrimination.

Description of Bill

Include in income all punitive damages

The bill would generally provide that the exclusion from gross income does not apply to any punitive damages received on account of personal injury or sickness whether or not related to a physical injury or physical sickness. Under the bill, present law would continue to apply to punitive damages received in a wrongful death action if the applicable State law (as in effect on September 13, 1995 without regard to subsequent modification) provides, or has been construed to provide by a court decision issued on or before such date, that only punitive damages may be awarded in a wrongful death action. The bill would intend no inference as to the application of the exclusion to punitive damages prior to the effective date of the bill in connection with a case involving a physical injury or physical sickness.

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[11] The Supreme Court recently agreed to decide whether punitive damages awarded in a physical injury lawsuit are excludable from gross income. O'gilvie v. U.S., 66 F.3d 1550 (10th Cir. 1995), cert. granted, 64 U.S.L.W. 3639 (U.S. March 25, 1996)(No. 95-966). Also, the Tax Court recently held that if punitive damages are not of a compensatory nature, they are not excludable from income, regardless of whether the underlying claim involved a physical injury or physical sickness. Bagley v. Commissioner, 105 T.C. No. 27 (1995).

[12] Schleier v. Commissioner, 115 S. Ct. 2159 (1995).

Include in income damage recoveries for nonphysical injuries

The bill would provide that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom would be treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse would be excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death would continue to be excludable from taxable income as under present law.

The bill also would specifically provide that emotional distress is not considered a physical injury or physical sickness.[13] Thus, the exclusion from gross income would not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income would apply to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income specifically would apply to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

The bill would intend no inference as to the application of the exclusion to damages prior to the effective date of the bill in connection with a case not involving a physical injury or physical sickness.

Effective Date

The provisions generally would be effective with respect to amounts received after June 30, 1996. The provisions would not apply to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

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[13] It would be intended that the term emotional distress would include physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress.

6. Repeal advance refunds of diesel fuel tax for purchasers of diesel-powered automobiles, vans, and light trucks

Present Law

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

Description of Bill

The tax credit for purchasers of diesel-powered automobiles, vans, and light trucks would be repealed.

Effective Date

The provision would be effective for vehicles purchased after the date of enactment.

IV. TECHNICAL CORRECTIONS PROVISIONS

A. Technical Corrections to the Revenue Reconciliation Act of 1990

1. Application of the 2.5-cents-per-gallon tax on fuel used in rail transportation to States and local governments

The bill would clarify that the 2.5-cents-per-gallon tax on fuel used in rail transportation does not apply to such uses by States and local governments.

2. Small winery production credit and bonding requirements

The bill would clarify that wine produced by eligible small wineries may be transferred without payment of tax to bonded warehouses that become liable for payment of the wine excise tax without losing credit eligibility.

3. Deposits of Railroad Retirement Tax Act taxes

The bill would conform the Internal Revenue Code to the provision in the Railroad Retirement Solvency Act of 1993 that applies the deposit rules for income taxes withheld from employees' wages and FICA taxes to Railroad Retirement Tax Act taxes.

4. Treatment of salvage and subrogation of property and casualty insurance companies

The bill would make adjustments to the calculation of a property and casualty insurance company's earnings and profits, so as to equalize the treatment of companies that did, and those that did not, take into account estimated salvage and subrogation recoverable in determining losses incurred prior to 1990.

5. Information with respect to certain foreign-owned or foreign corporations: Suspension of statute of limitations during certain judicial proceedings

The bill would modify the provisions in sections 6038A and 6038C that suspend the statute of limitations to clarify that the suspension applies to any taxable year the determination of the amount of tax imposed for which is affected by the transaction or item to which the summons relates.

6. Rate of interest for large corporate underpayments

The bill would provide that an IRS notice that is later withdrawn because it was issued in error does not trigger the higher rate of interest applicable to certain corporate underpayments.

7. Research credit provision: Effective date for repeal of special proration rule

The bill would repeal for all taxable years ending after December 31, 1989, the special proration rule for certain qualified research provided for by the 1989 Act.

8. Energy tax provision: Alternative minimum tax adjustment based on energy preferences

The bill would clarify that the amount of alternative tax net operating loss that is utilized in any taxable year is to be appropriately adjusted to take into account the amount of special energy deduction claimed for that year.

The bill also would provide that the ACE adjustment for taxable years beginning in 1991 and 1992 is to be computed without regard to the special energy deduction.

9. Estate tax freezes

Chapter 14 of the Code contains rules that supersede the willing buyer, willing seller standard for valuation of preferred interest in corporations and partnerships, property held in trust, and term interests in property.

The bill would provide that an applicable retained interest conferring a distribution right to qualified payments with respect to which there is no liquidation, put, call, or conversion right is valued without regard to section 2701. The bill also would provide that the retention of such right gives rise to potential inclusion in the transfer tax base.

The bill would modify the definition of junior equity interest by granting regulatory authority to treat a partnership interest with rights that are junior with respect to either income or capital as a junior equity interest. The bill also would modify the definition of distribution right by replacing the junior equity interest exception with an exception for a right under an interest that is junior to the rights of the transferred interest.

The bill would modify the rules for electing into or out of qualified payment treatment. A dividend payable on a periodic basis and at a fixed rate under a cumulative preferred stock held by the transferor is treated as a qualified payment unless the transferor elects otherwise. If held by an applicable family member, such stock is not treated as a qualified payment unless the holder so elects. In addition, a transferor or applicable family member holding any other distribution right may treat such right as a qualified payment to be paid in the amounts and at the times specified in the election.

The bill would grant the Treasury Department regulatory authority to make subsequent transfer tax adjustments to reflect the inclusion of unpaid amounts with respect to a qualified payment. The bill would treat a transfer to a spouse falling under the annual exclusion the same as a transfer qualifying for the marital deduction. The bill also would clarify that the inclusion

continues to apply if an applicable family member transfers a right to qualified payments to the transferor. Under the bill, the election to treat a distribution as giving rise to an inclusion would result in an inclusion only with respect to the payment for which the election is made.

The bill would conform section 2702 to existing regulatory terminology by substituting the term "incomplete gift" for "incomplete transfer." In addition, the bill would limit the exception for incomplete gifts to instances in which the entire gift is incomplete. The Treasury Department would be granted regulatory authority, however, to create additional exceptions not inconsistent with the purposes of the section.

10. Conforming amendments to the repeal of the General Utilities doctrine

The bill would make three conforming changes to the Code with respect to the repeal of the General Utilities doctrine. Two of the changes affect section 1248: the first includes a reference to section 355(c)(1) and the second clarifies that, with respect to any transaction in which a U.S. person is treated as realizing gain from the sale or exchange of stock of a controlled foreign corporation, the U.S. person shall be treated as having sold or exchanged the stock for purposes of applying section 1248. The third change repeals section 897(f) as deadwood.

11. Prohibited transaction rules

The bill would conform the statutory language to legislative intent by providing that transactions that are exempt from the prohibited transaction rules of the Employee Retirement Income Security Act of 1974 ("ERISA") by reason of ERISA section 408(b)(12) are also exempt from the prohibited transaction rules of the Code.

12. Effective date of LIFO adjustment for purposes of computing adjusted current earnings

The bill would clarify that the calculation of the LIFO adjustment of the adjusted current earnings component of the corporate alternative minimum tax would be effective with respect to adjustments occurring in taxable years beginning after December 31, 1989.

13. Low-income housing tax credit

The bill would repeal a 1990 technical correction regarding treatment of low-income housing buildings financed with tax-exempt bonds. The bill would provide, however, that pre-1989 Act law will apply to a bond-financed building if the owner of the building establishes to the satisfaction of the Secretary of the Treasury reasonable reliance upon the 1990 technical correction.

14. Expired or obsolete provisions ("deadwood provisions")

The bill would make several amendments to restore the substance of prior law which was

inadvertently changed by the deadwood provisions of the 1990 Act. These amendments include a provision that would restore the prior-law rule providing that if any member of an affiliated group of corporations elects the credit under section 901 for foreign taxes paid or accrued, then all members of the group paying or accruing such taxes must elect the credit in order for any dividend paid by a member of the group to qualify for the 100-percent dividends received deduction (sec. 243(b)). The bill also would make several nonsubstantive clerical amendments to conform the Code to the amendments made by the deadwood provisions. None of these amendments is intended to change the substance of pre-1990 law.

B. Technical Corrections to the Revenue Reconciliation Act of 1993

1. Treatment of full-time students under the low-income housing credit

The bill would provide that the full-time student provision is effective on the date of enactment of the Revenue Reconciliation Act of 1993 ("1993 Act").

2. Indexation of threshold applicable to excise tax on luxury automobiles

The bill would correct the application of the indexing adjustment applicable to the threshold above which the excise tax on luxury automobiles is to apply so that the adjustment calculated for a given calendar year applies for that calendar year rather than in the subsequent calendar year. The provision would be effective on the date of enactment.

3. Indexation of the limitation based on modified adjusted gross income for income from United States savings bonds used to pay higher education tuition and fees

The bill would correct the indexing of the $60,000 ($40,000 for taxpayers filing as single) threshold to provide that the thresholds be indexed for inflation after 1989.

4. Reporting and notification requirements for lobbying and political expenditures of tax-exempt organizations

Tax-exempt organizations that incur political expenditures are subject to tax under section 527(f). Section 6033(e) requires tax-exempt organizations (other than charities) to (1) report on their annual information returns both the total amount of their lobbying and political expenditures, and the total amount of dues payments allocable to such expenditures, and (2) provide notice to their members of the portion of dues allocable to lobbying and political expenditures (so that such amounts are not deductible to members), or the organization may elect to pay a proxy tax on its lobbying and political expenditures, up to the amount of its dues receipts. The bill would amend section 6033(e) to clarify that any political expenditures on which tax is paid pursuant to section 527(f) are not subject to the reporting and notification requirements of section 6033(e). In addition, the bill would clarify that the reporting and notification requirements of section 6033(e) apply to organizations exempt from tax under section 501(a), other than charities described in section 501(c)(3).

5. Estimated tax rules for certain tax-exempt organizations

The bill would clarify that the Revenue Reconciliation Act of 1993 did not change the method by which a tax-exempt organization annualizes its current year tax liability for purposes of avoiding an underpayment of estimated tax.

6. Current taxation of certain earnings of controlled foreign corporations -- application of foreign tax credit limitation

The bill would clarify that a U.S. shareholder's inclusion of a controlled foreign corporation's earnings invested in excess passive assets is treated like a dividend for purposes of the foreign tax credit limitation.

7. Current taxation of certain earnings of controlled foreign corporations--measurement of accumulated earnings

The bill would clarify that the accumulated earnings and profits of a controlled foreign corporation taken into account for purposes of determining the foreign corporation's earnings invested in excess passive assets do not include any deficit in accumulated earnings and profits, and do not include current earnings (which are taken into account separately).

8. Current taxation of certain earnings of controlled foreign corporations--aggregation and look-through rules

The bill would clarify that, within the regulatory authority provided to the Secretary of the Treasury under the 1993 Act, regulations are specifically authorized to coordinate the CFC group treatment and look-through treatment applicable for purposes of determining a foreign corporation's earnings invested in excess passive assets. Pending the promulgation of guidance by the Secretary, it would be intended that taxpayers be permitted to coordinate such treatment using any reasonable method for taking assets into account only once, so long as the method is consistently applied to all controlled foreign corporations (whether or not members of any CFC group) in all taxable years.

9. Treatment of certain leased assets for PFIC purposes

The bill would clarify that, in the case of any item of property leased by a foreign corporation and treated as an asset actually owned by the foreign corporation in measuring the assets of the foreign corporation for purposes of the PFIC asset test, the amount taken into account with respect to the leased property is the amount determined under the 1993 Act's special measurement rule, which is based on the unamortized portion of the present value of the payments under the lease for the use of the property.

10. Amortization of goodwill and certain other intangibles

The bill would clarify the antichurning rules of the 1993 Act amortization of intangibles provision. It is clarified that when a taxpayer and its related parties have made an election to apply the 1993 Act to all acquisitions after July 25, 1991, the antichurning rules will not apply when property acquired from an unrelated party after July 25, 1991 (and not subject to the antichurning rules in the hands of the acquirer) is transferred to a taxpayer related to the acquirer after the date of enactment of the 1993 Act.

11. Empowerment zones and eligibility of small farms for tax incentives

The bill would provide that the $500,000 asset test for determining whether a farm is eligible for section 179 expensing in an empowerment zone and expanded tax-exempt financing benefits in an empowerment zone or enterprise community is applied based on assets of the farm at the end of the current taxable year.

C. Other Tax Technical Corrections

1. Hedge bonds

The bill would clarify that the 30-day exception for temporary investments of investment earnings applies to amounts (i.e., principal and earnings thereon) temporarily invested during the 30-day period immediately preceding redemption of the bonds as well as such periods preceding reinvestment of the proceeds.

2. Withholding on distributions from U.S. real property holding companies

The bill would clarify that withholding requirements under section 1445 apply to any section 301 distribution to a foreign person by a domestic corporation that is or was a U.S. real property holding corporation which distribution is not made out of the corporation's earnings and profits and is therefore treated as an amount received in a sale or exchange of a U.S. real property interest. The provision would be effective for distributions made after the date of enactment.

3. Treatment of credits attributable to working interests in oil and gas properties

A working interest in an oil and gas property which does not limit the liability of the taxpayer is not a "passive activity" for purposes of the passive loss rules (sec. 469). However, if any loss from an activity is treated as not being a passive loss by reason of being from a working interest, any net income from the activity in subsequent years is not treated as income from a passive activity, notwithstanding that the activity may otherwise have become passive with respect to the taxpayer.

The bill would clarify that any credit attributable to a working interest in an oil and gas property, in a taxable year in which the activity is no longer treated as not being passive activity, will not be treated as attributable to a passive activity to the extent of any tax allocable to the net income from the activity for the taxable year.

4. Clarification of passive loss disposition rule

The bill would clarify the rule relating to the computation of the overall loss allowed upon the disposition of a passive activity under the passive loss rules.

5. Estate tax unified credit allowed nonresident aliens under treaty

The bill would clarify that in determining the pro rata unified credit required by treaty, property exempted by the treaty from U.S. estate tax is not treated as situated in the United States. The provision would be effective on the date of enactment.

6. Limitation on deduction for certain interest paid by corporation to related person

The bill would clarify that, under the earnings stripping provision, excess interest carried forward from a year in which the debt-equity ratio threshold is exceeded may be deducted in a subsequent year in which that threshold is not exceeded, but only to the extent that such interest would not otherwise be treated as excess interest expense in the carryforward year. The provision would be effective as if included in the amendments made by section 7210(a) of the 1989 Act.

7. Branch-level interest tax

The bill would clarify that where an interest expense of a foreign corporation is allocable to U.S. effectively connected income, but that interest expense would not have been fully deductible for tax purposes under another Code provision had it been paid by a U.S. corporation, such interest is nonetheless treated for branch level interest tax purposes like a payment by a U.S. corporation to a foreign corporate parent. Similarly, with regard to the Treasury's regulatory authority to treat an interest payment by a foreign corporation's U.S. branch as though not paid by a U.S. person for source and withholding purposes, the bill would clarify that the authority extends to interest payments in excess of those reasonably expected to be allocable to U.S. effectively connected income of the foreign corporation. These provisions would be effective as if they were made by the Tax Reform Act of 1986 ("1986 Act").

8. Determination of source in case of sales of inventory property

The bill would clarify that, to the extent that the Secretary of the Treasury had general regulatory authority to provide rules for the sourcing of income from the sales of personal property prior to the 1986 Act, the Secretary of the Treasury retains that authority under present law with respect to inventory property. The provision would be effective as if it were included in the 1986 Act.

9. Repeal of obsolete provisions

The bill would repeal as obsolete the information reporting requirements of sections 6038 and 6038A relating to section 453C.

10. Clarification of certain stadium bond transition rule in Tax Reform Act of 1986

The bill would permit the residual interest in the stadium currently held by the City of Cleveland to be assigned to Cuyahoga County, Ohio (the county in which both Cleveland and the stadium are located) because of a change in Ohio State law prior to issuance of the bonds. The bill would not extend the time for issuing the bonds or otherwise affect the amount of bonds or the location or design of the stadium.

11. Health care continuation rules

The 1989 Act amended the health care continuation rules to provide that if a covered employee is entitled to Medicare and within 18 months of such entitlement separates from service or has a reduction in hours, the duration of continuation coverage for the spouse and dependents is 36 months from the date the covered employee became entitled to Medicare. One possible unintended interpretation of the statutory language, however, would permit continuation coverage for up to 54 months. The bill would amend the Code (sec. 4980B), title I of the Employee Retirement Income Security Act of 1974 (sec. 602), and the Public Health Service Act (sec. 2202(2)(A)), to limit the continuation coverage in such cases to no more than 36 months. The provision would be effective for plan years beginning after December 31, 1989.

12. Taxation of excess inclusions of a residual interest in a REMIC for taxpayers subject to alternative minimum tax with net operating losses

The bill would provide the following three rules for determining the alternative minimum taxable income of a taxpayer that is not a thrift institution that holds residual interests in a REMIC: (1) the alternative minimum taxable income of such a taxpayer is computed without regard to the REMIC rule that taxable income cannot be less than the amount of excess inclusions; (2) the alternative minimum taxable income of such a taxpayer for a taxable year cannot be less than the excess inclusions of the residual interests for that year; and (3) the amount of any alternative minimum tax net operating loss deduction of such a taxpayer is computed without regard to any excess inclusions. The provision would be effective for all taxable years beginning after December 31, 1986, unless the taxpayer elects to apply the rules of the bill only to taxable years beginning after the date of enactment.

13. Application of harbor maintenance tax to Alaska and Hawaii ship passengers

The bill would clarify that the harbor maintenance tax does not apply to passenger fares where the passengers are transported on U.S. flag vessels operating solely within the State waters of Alaska or Hawaii and adjacent international waters (i.e., leaving and returning to a port in the same State without stopping elsewhere). The provision would be effective as of April 1, 1987 (the effective date of the tax).

14. Modify effective date provision relating to the Energy Policy Act of 1992

The bill would correct several cross-references in the Energy Policy Act of 1992, and also clarifies the relationship between the basis adjustment rules for the electric vehicle credit (sec. 30(d)(1) and the alternative minimum tax.

15. Determination of unrecovered investment in annuity contract

In the case of an annuity contract with a refund feature, the bill would modify the definition of the unrecovered investment in the contract, so that the entire investment in the

contract can be recovered tax-free.

16. Election by parent to claim unearned income of certain children on parent's return

The bill would provide for adjustments for inflation, effective for taxable years beginning after December 31, 1995.

17. Exclusion from income for combat zone compensation

The bill would change obsolete references to "combat pay" to references to "combat zone compensation."

D. Additional Tax Technical Corrections

1. Reporting of real estate transactions

The bill would clarify that real estate reporting persons may take into account the cost of complying with the reporting requirements of Code section 6045 in establishing charges for their services, so long as a separately listed charge for such costs is not made.

2. Clarification of denial of deduction for stock redemption expenses

The bill would clarify that amounts properly allocable to indebtedness on which interest is deductible and properly amortized over the term of that indebtedness are not subject to the provision of section 162(k) denying a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock. This clarification would be effective as if included in the 1986 Act.

In addition, the bill would clarify that the rules of section 162(k) apply to any acquisition of its stock by a corporation or by a party that has a relationship to the corporation described in section 465(b)(3)(C)(which applies a more than 10-percent relationship test in certain cases). These clarifications would apply to amounts paid or incurred after September 13, 1995.

3. Clarification of depreciation class for certain energy property

The bill would clarify that solar or wind property owned by a public utility may qualify as 5-year MACRS property.

4. Treatment of certain veterans' reemployment rights

The bill would conform the Internal Revenue Code provisions relating to tax-qualified retirement plans to the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), which provides for the rights of reemployed veterans. Thus, under the bill, the tax-qualified status of a plan would not be affected merely because the plan provides benefits to a reemployed veteran as required or authorized by USERRA. The provision would be effective as of December 12, 1994, the effective date of the benefits-related provisions of USERRA.

5. Treat qualified football coaches plan as multiemployer pension plan for purposes of the Internal Revenue Code

Under the bill, a correction to the Continuing Appropriations for Fiscal Year 1988 would provide that a qualified football coaches plan (as defined in the Employee Retirement Income Security Act of 1974) is eligible to maintain a qualified cash or deferred arrangement under the Internal Revenue Code on behalf of the football coaches belonging to the American Football Coaches Association. The provision generally would be effective as if included in the Continuing Appropriations for Fiscal Year 1988 (i.e., years beginning after December 22, 1987).

E. Interaction Between Passive Activity Loss Rules and Earnings Stripping Rules

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. Deductions and credits that are suspended are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person. In determining passive activity deductions, Treasury regulations provide that "an item of deduction arises in the taxable year in which the item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to sections 469, 613A(d) and 1211" (Treas. Reg. sec. 1.469-2(d)(8)). Thus, these regulations effectively require other limitations to be applied before applying the passive loss rules.

The at-risk rules limit deductible losses from an activity to the amount that the taxpayer has at risk, in the case of an individual or a closely-held corporation (sec. 465). The amount at risk is generally the sum of (1) cash contributions, (2) the adjusted basis of contributed property, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged as security property not used in the activity. The amount at risk is increased by income from the activity and decreased by losses and withdrawals.

A taxpayer generally may deduct interest paid or accrued on indebtedness within a taxable year (sec. 163(a)). The Revenue Reconciliation Act of 1989 (the "1989 Act") added an "earnings stripping" limitation on interest deductibility with respect to certain interest paid by corporations to related persons (sec. 163(j)). If the provision applies to a corporation for a taxable year, it disallows deductions for certain amounts of "disqualified interest" paid or accrued by the corporation during that year. Disqualified interest is interest paid by a corporation to related persons that are not subject to U.S. tax on the interest received. The disallowed amount is treated under the earnings stripping provision as disqualified interest paid or accrued in the succeeding taxable year. Proposed Treasury regulations would provide that "sections 465 and 469 shall be applied before applying section 163(j)" (Prop. Treas. Reg. sec. 1.163(j)-7(b)(3)).

Description of Bill

The bill would modify section 163(j) of the Code to clarify that the earnings stripping rules apply before the passive loss rules and the at-risk rules.

Effective Date

The provision would be effective as if included in the 1989 Act.

F. Definition of Passive Income in Determining Passive Foreign Investment Company Status

Present Law

Export foreign corporations (ETCs) are controlled foreign corporations (CFCs) that are allowed to defer a portion of their income from qualifying export activities. In 1971, the ETC provisions were replaced by rules applicable to domestic international sales corporations (DISCs). Only those ETCs in existence at that time are allowed to continue operating as ETCs. In 1984, the DISC provisions were largely replaced by the rules applicable to foreign sales corporations (FSCs). Certain foreign trade income of a FSC is exempt from U.S. income tax. In addition, a domestic corporation is allowed a 100-percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income.

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies (PFICs). A foreign corporation is a PFIC if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average amount of its assets consists of assets that produce, or are held for the production of passive income. Passive income for this purpose generally means income that satisfies the definition of foreign personal holding company income under subpart F. Foreign personal holding company income generally includes interest, dividends, and annuities; certain rents and royalties; related party factoring income; net commodities gains; net foreign currency gains; and net gains from sales or exchanges of certain other property. In determining whether a foreign corporation is a PFIC, passive income does not include certain active-business banking, insurance, or (in the case of the U.S. shareholders of a CFC) securities income, or certain amounts received from a related party (to the extent that the amounts are allocable to income of the related party which is not passive income).

Description of Bill

The bill would clarify that foreign trade income of a FSC and export trade income of an ETC do not constitute passive income for purposes of the PFIC definition.

Effective Date

The provision would be effective as if it were included in the Tax Reform Act of 1986.