



JOINT COMMITTEE ON TAXATION

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SUMMARY OF JOINT COMMITTEE STAFF “OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES”

Pursuant to a request from Senate Finance Committee Chairman Charles Grassley and Ranking Member Max Baucus, the staff of the Joint Committee on Taxation issued a report on January 27, 2005, on various options to improve tax compliance and reform tax expenditures. This document provides a summary of those options.¹

I. TAX PROCEDURE AND ADMINISTRATION

A. Impose Withholding on Certain Payments Made by Government Entities

Employers are required to withhold income tax on wages paid to employees, including wages and salaries of employees and elected officials of Federal, State, and local government units. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee. Withholding does not apply to most non-wage payments.

The lack of a withholding mechanism on non-wage payments leads to substantial underpayments of tax each year and has long been identified as contributing to the tax gap. According to the most recent IRS report on the tax gap and consistent with earlier reports, the underreporting of “non-farm proprietor net income” – in general, compensation income of sole proprietors not subject to wage withholding – is the single largest contributor to the tax gap. Payments made by Federal, State, and local governments represent a significant amount of those annual payments that are not subject to withholding. Imposing withholding on non-wage payments made by Federal, State, and local governments would improve taxpayer compliance, reduce the tax gap, and promote fairness.

¹ For a detailed description of the options, see the complete report: Joint Committee on Taxation, “*Options to Improve Tax Compliance and Reform Tax Expenditures*,” (JCS-02-05), January 27, 2005.

The proposal requires withholding at a three-percent rate on payments for goods and services² made by all branches of the Federal government and its agencies and all units of State and local governments. Local governments with less than \$100 million of annual expenditures are excluded from the withholding requirement. The proposal also imposes information reporting requirements on payments that are subject to withholding under the proposal but are not subject to information reporting under present law.

B. Require Partial Payments with Submission of Offers-in-Compromise

The Federal government may compromise any civil or criminal case arising under the internal revenue laws. In general, taxpayers initiate this process by making an offer-in-compromise, which is an offer by the taxpayer to settle an outstanding tax liability for less than the total amount due. The IRS currently imposes a user fee of \$150 on most offers, payable upon submission of the offer to the IRS. Taxpayers may justify their offers on the basis of doubt as to collectibility or liability or on the basis of effective tax administration. In general, enforcement action is suspended during the period that the IRS evaluates an offer. In some instances, it may take the IRS 12 to 18 months to evaluate an offer. Taxpayers are permitted (but not required) to make a deposit with their offer; if the offer is rejected, the deposit is generally returned to the taxpayer.

In general, submission of an offer indicates that the taxpayer is willing and able to make a partial payment of the taxpayer's liability. Because of the lengthy review process that the IRS undertakes prior to accepting an offer, there may be a substantial period of time before the IRS actually collects the amounts the taxpayer is willing to pay. Moreover, experience under present law has shown that in some cases taxpayers do not make offers in good faith (e.g., by concealing information from the IRS). Requiring partial payment with the submission of an offer-in-compromise will preserve the offer program for those cases in which it is appropriate, and will increase fairness for those taxpayers who pay their taxes in full. Thus, the proposal requires that a taxpayer make partial payments while the taxpayer's offer is being considered by the IRS. These payments are retained and applied to the taxpayer's outstanding balance, even if the taxpayer's offer is ultimately rejected as inadequate.

C. Clarify Standards of Scrutiny for Certain Transactions with Characteristics of Tax Shelters

Recent tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by Congress. A strictly rule-based tax system cannot prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement tax rules with anti-avoidance standards, such as the "economic substance" doctrine, in order to assure the Congressional

² Thus, the proposal does not apply, for example, to welfare and other types of public assistance payments. The proposal also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intra-governmental payments; and payments made pursuant to a classified or confidential contract.

purpose is achieved. Under present law, there is a lack of uniformity among the courts regarding the application of the economic substance doctrine.

The proposal provides a uniform standard for applying the economic substance doctrine to transactions having any of six characteristics present in many tax shelters.³ Under the uniform standard, for a transaction to have economic substance, a taxpayer must demonstrate that the transaction had a substantial non-tax purpose and changed the taxpayer's economic position in a meaningful way (apart from Federal tax consequences). The fact that financial accounting benefits would result from the desired tax treatment is not itself an allowable non-tax purpose. For transactions other than those with any of the six characteristics, the proposal retains present law.

³ The six types of transactions to which the proposal applies are transactions: 1) in which the taxpayer holds offsetting positions which substantially reduce the risk of loss and tax benefits would result from differing tax treatment of the positions; 2) which are structured to result in a disparity between basis and fair market value which creates or increases a loss or reduces a gain; 3) which are structured to create or increase a gain in any asset any portion of which would not be recognized for Federal income tax purposes if the asset were sold at fair market value by the taxpayer (or a related person); 4) which are structured to result in income for Federal income tax purposes to a tax indifferent party for any period which is materially in excess of any economic income to such party with respect to the transaction for such period; 5) in which the taxpayer disposes of certain property which the taxpayer held at risk for a period of less than 45 days; or 6) which are structured to result in a deduction or loss which is otherwise allowable for Federal tax purposes but not for financial accounting purposes. The Treasury Department may by regulations add or subtract types of transactions from this list.

II. INDIVIDUAL INCOME TAX

A. Provide Uniform Treatment for Dependent Care Benefits (secs. 21 and 129⁴)

Present law provides two separate tax benefits for dependent care expenses: the dependent care credit and the exclusion for employer provided dependent care expenses. Whether the credit or the exclusion is more favorable depends on the taxpayer's circumstances; however, in many cases the exclusion provides more favorable tax benefits. For example, the amount of the credit, but not the exclusion, is dependent on whether the taxpayer has one or more than one qualifying individuals; the credit is reduced for persons with incomes above certain levels, whereas the exclusion is not limited based on income; and, for taxable years beginning after 2005, the exclusion will continue to apply in determining alternative minimum taxable income, but the credit will not offset alternative minimum tax liability.

The two different provisions for similar expenses create inequity in the operation of the tax laws because the same benefit is not available to all taxpayers. The differing benefits also add to complexity as taxpayers may need to determine which provision produces the best tax result for them.

Under the proposal, the dependent care tax credit is the sole means of providing a tax benefit for dependent care expenses. The proposal is designed to provide greater equity among similarly situated taxpayers and simplify the treatment of dependent care expenses.

B. Combine Hope and Lifetime Learning Credits and the Above-the-Line Deduction for Higher Education Expenses (secs. 25A and 222)

The proposal combines the Hope and Lifetime Learning credits and the above-the-line deduction for qualified higher education expenses into a single credit. The proposal is intended to promote simplicity in delivering education tax benefits. The proposed credit applies on a per-student basis (as under the Hope credit) and to qualified education expenses for both graduate and undergraduate education without regard to enrollment status (i.e., halftime or otherwise) (as under the Lifetime Learning credit). Providing such benefits on a per-student basis, rather than a per-tax return basis (as is the case for the Lifetime Learning credit), would promote greater fairness by allowing the credit to vary more directly with the number of students in a family.

The credit equals 25 percent of the first \$10,000 of qualified expenses per student. The otherwise allowable aggregate credit per tax return is phased out by \$50 for each \$1,000 that adjusted gross income exceeds \$70,000 (\$140,000 if married filing a joint return).⁵ The credit is allowed against the alternative minimum tax.

⁴ Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.

⁵ The credit rate, expense limitation, and phaseout ranges were chosen to create an approximately revenue neutral proposal over the period 2006-2014 under the assumption that the baseline includes

C. Repeal Exclusion for Qualified Tuition Reductions (sec. 117(d))

If certain requirements are satisfied, present law provides an exclusion from gross income and wages for amounts received as a qualified tuition reduction. In general, a qualified tuition reduction is the amount of any reduction in tuition provided to employees of qualifying educational organizations for the education below the graduate level (including primary and secondary school) of the employee (and the employee's spouse and dependents) at such organizations or other qualifying educational organizations. The exclusion also applies to graduate level education in the case of a graduate student who is engaged in teaching or research activities at the educational organization. However, the exclusion does not apply to the extent the tuition reduction is payment for teaching or other services provided by the student.

The exclusion for qualified tuition reductions raises fairness concerns because it is available only to a limited group of taxpayers, as compared to other present-law provisions which provide tax benefits relating to education much more broadly. The exclusion also adds complexity and a source of noncompliance due to the need to make factual determinations in some cases, for example, determining if the tuition reduction is compensation for services.

The proposal repeals the exclusion for qualified tuition reductions. Under the proposal, such benefits are included in gross income and are treated as wages for employment tax purposes. Tuition reductions that are includible in income under the proposal would be eligible for the generally available benefits for education expenses, provided the requirements for such benefits are otherwise satisfied.

D. Deny Refundable Child Credit When Section 911 Exclusion Is Elected (sec. 24)

The refundable child credit is generally intended to apply to working families of sufficiently low economic income. Under present law, however, because earned income must be included in gross income in order to be considered earned income for purposes of the earned income credit and the refundable child credit, taxpayers working abroad and claiming an exclusion under section 911 are potentially eligible for a refundable child credit only if their income is sufficiently high. Specifically, the refundable credit becomes payable for taxpayers working abroad, and electing the section 911 exclusion, once the taxpayer's earned income exceeds \$90,900 (section 911 exclusion of \$80,000 plus the refundable child credit earned income threshold of \$10,900 for 2005). This permits certain high-income taxpayers to receive the refundable child credit, which is intended for low-income taxpayers. The proposal denies a refundable child credit to anyone claiming the section 911 exclusion.

permanent extension of the above-the-line deduction and extension of provisions allowing nonrefundable personal credits against the alternative minimum tax. These assumptions were made for purposes of illustrating a possible credit and are based on the law in effect for 2005.

**E. Repeal the Deduction for Interest on Home Equity Indebtedness
(sec. 163)**

Under present law, a taxpayer may deduct interest on a loan of up to \$100,000 secured by his or her residence. This deduction acts as a disincentive to savings and is unrelated to the purpose of encouraging home ownership. Further, the present-law home equity indebtedness rules provide inconsistent treatment by allowing deductible interest for homeowners' consumption spending that is not allowed to similarly situated non-homeowners. Finally, the present-law rule that home equity interest is only deductible for indebtedness up to the amount that the fair market value of the home exceeds acquisition indebtedness adds complexity to the tax law by requiring the homeowner to determine the fair market value of the home on a periodic basis. The proposal repeals the deduction for interest on home equity indebtedness.

**F. Limit the Exclusion for Rental Value of a Residence Rented
for Fewer than 15 Days (sec. 280A)**

Gross income generally includes all income from whatever source derived, including rent from real property. Present law provides a de minimis exception to this rule if a dwelling unit is used during the taxable year by the taxpayer as a residence and is rented for fewer than 15 days during the taxable year. In this case, the rental income is not included in gross income. No deductions attributable to such rental use are allowed.

The present-law 15-day rule inaccurately measures economic income by excluding rental income earned by the taxpayer. The amount of the untaxed income can be significant even for fewer than 15 days' rental. A dollar limitation in conjunction with the 15-day rule would more accurately function as a de minimis threshold than a rule based exclusively on the rental period.

The proposal limits the total exclusion for the rental value of a residence rented fewer than 15 days to \$2,000. Under the proposal, a taxpayer may claim the otherwise allowable deductions attributable to such rental use (e.g., depreciation) reduced in proportion to the ratio of excludable rental income to total rental income from the property.

**G. Extend Pro-Rata Basis Allocation Requirement to All Part-Gift,
Part-Sale Transactions (sec. 1011)**

In general, when a taxpayer sells part of a larger property, the taxpayer is required to allocate basis to the portion sold based on that portion's fair market value. Present law governing bargain sales to charities is consistent with this principle. Present law for other bargain sales, however, departs from this general rule and allocates the entire basis to the sale portion, thereby reducing the taxable gain for taxpayers making those sales. As a result, similar transactions are treated differently. Moreover, the taxable gain of each party to a part-gift, part-sale transaction not involving a charity is measured incorrectly.

The proposal extends to all part-gift, part-sale transfers the present law pro rata basis allocation rule applicable to bargain sales to charities. Consequently, for determining gain from any bargain sale, the proposal requires a taxpayer to allocate to the sale portion of property an amount of basis equal to that portion's pro rata share, based on respective fair market values, of the entire property's adjusted basis.

H. Simplify Taxation of Minor Children (sec. 1)

The amount of net unearned income of a child under age 14 that exceeds an annual inflation-adjusted amount generally is taxed at the parents' highest marginal rate. This is commonly referred to as the "kiddie tax" and is designed to lessen the effectiveness of intra-family transfers of income-producing property. Without the kiddie tax, certain parents in high tax brackets could reduce their family's overall income tax liability by shifting income-producing property to their children, who generally fall into lower tax brackets. In some circumstances, parents may elect to treat their children's income as their own, which avoids the need to file multiple tax returns but may result in higher tax liability.

The present-law kiddie tax provisions are complex and lead to uncertainty about the tax rate that will apply to a child's unearned income. A main source of complexity is that present law requires a linkage between the child's return, the parent's return, and if applicable, the returns of the child's siblings. This linkage increases complexity in the initial filing of the child's return, and in subsequent filings or proceedings if the return of the child, the parent, or a sibling is amended or adjusted under audit. The rules are further complicated depending on whether the child's parents file jointly, separately, are married, unmarried, or remarried.

The proposal generally increases the age of children to which the kiddie tax provisions apply from under 14 to under 18. The proposal also eliminates the parental election and subjects a child's unearned income in excess of an exemption amount to the highest individual income tax rate applicable to income of that character, rather than to his or her parents' marginal rate. Thus, under the proposal, a child's income tax liability would no longer be determined by reference to parental income or filing status.

III. EMPLOYMENT TAXES

A. Provide Consistent FICA Treatment of Salary Reduction Amounts (sec. 3121(a))

Present law provides inconsistent treatment of salary reduction amounts for purposes of the Federal Insurance Contributions Act (“FICA”). Contributions made to tax-favored retirement plans by salary reduction are wages that are subject to FICA taxes. However, salary reduction amounts used to provide certain other benefits are exempt from FICA taxes, such as health benefits and dependent care assistance provided under a cafeteria plan and qualified transportation fringe benefits.

Legislative history indicates that the treatment of contributions made to tax-favored retirement plans by salary reduction as FICA wages is intended to assure that salary reduction amounts are included in the FICA base. Otherwise, individuals could, in effect, control which portion of their compensation is included in wages for Social Security purposes. This rationale applies equally to salary reduction amounts used to provide benefits under a cafeteria plan or qualified transportation fringe benefits.

The proposal provides consistent treatment of salary reduction amounts for FICA purposes. Specifically, salary reduction amounts used to provide benefits under a cafeteria plan or to provide qualified transportation fringe benefits are included in FICA wages in a manner similar to salary reduction contributions to employer-sponsored retirement plans.

B. Conform Calculation of FICA Taxes and SECA Taxes (sec. 1402(a)(12))

The Social Security Act amendments of 1983 were intended to place taxes paid under the Self Employment Compensation Act (“SECA”) on the same economic footing as FICA taxes. This involved equalizing the FICA and SECA tax rates for the first time. At the same time, self-employed taxpayers were allowed a deduction from self-employment earnings in recognition of the fact that such earnings include the “employer share” of SECA taxes, whereas FICA tax rates apply to wages exclusive of the employer share of FICA tax. However, due to a mathematical inconsistency in the calculation of the deduction for SECA purposes, self-employment income is taxed more favorably than wages. The proposal modifies the formula for calculating the deduction from self-employment earnings to make SECA taxes economically equivalent to FICA taxes.

C. Extend Medicare Payroll Tax to All State and Local Government Employees (sec. 3121(u)(2))

Under present law, employees of the Federal government and private employers are subject to Medicare payroll taxes, regardless of their dates of hire. However, certain State and local government workers are not covered by Medicare or the corresponding payroll taxes if they were hired before March 31, 1986. State and local government employees who are not subject to Medicare taxes may receive the same benefits as other workers, either through other employment or spousal coverage. The proposal extends Medicare and the corresponding payroll taxes to State and local government employees regardless of their date of hire.

**D. Modify FICA Tax Exception for Students
(sec. 3121(b)(10))**

FICA taxes do not apply to compensation for services performed in the employ of a school, college, or university by a student who is enrolled and regularly attending classes at such institution (referred to as the “student exception”). The legislative history of the student exception provides that the exception is intended to apply to situations in which the employment is part-time or intermittent and the total amount of earnings is only nominal, the payment of tax is inconsequential and a nuisance, and the related benefit rights are also inconsequential.

The scope of the exception has been the subject of uncertainty in recent years. It appears that the student exception may be viewed by certain taxpayers as applying more broadly to include situations that are similar to full-time employment. In addition, questions (and court cases) have arisen with respect to the application of the student exception to medical residents performing services at a university hospital or other medical facility. Although regulations issued by the IRS in December 2004 help to clarify the scope of the student exception, clear statutory standards would make the exception more administrable. In addition, the original intent of the exception can be implemented more effectively through a dollar limit.

The proposal codifies the IRS regulations relating to: (1) the definition of school, college, or university; and (2) student status. In addition, the proposal amends the student exception so that it applies only to individuals whose earnings from the school, college, or university are less than the amount needed to receive a quarter of social security coverage for the year (\$920 for 2005).

**E. Apply Employment Taxes to Sales Incentive Payments Made by Manufacturers
(secs. 3121 and 3401)**

Under current IRS guidance and practices, sales incentive payments made by manufacturers or distributors to employees of a dealer are not subject to either FICA or SECA taxes, even though such payments are compensation for services. Such payments, like other compensation paid to employees, should be subject to employment taxes.

Under the proposal, sales incentives payments made by manufacturers or distributors to sales people employed by dealers are wages for employment tax purposes. Thus, sales incentive payments are subject to FICA taxes (and income tax withholding).

**F. Modify Determination of Amounts Subject to Employment or Self-Employment
Tax for Partners and S Corporation Shareholders (sec. 1402)**

The employment tax treatment of members of a limited liability company (“LLC”) is uncertain. LLC members are generally treated as partners for Federal tax purposes but are neither general nor limited partners under applicable State law. LLC members may view themselves as comparable to limited partners, even though they are not limited partners under applicable State law. This uncertainty makes compliance with the law difficult for taxpayers and administration of the law difficult for the IRS.

It has become increasingly common for individuals who perform services in businesses that they own to choose the S corporation form to seek to reduce their FICA taxes. These S corporation shareholders pay themselves wages below the wage cap, while treating the rest of their compensation as a distribution by the S corporation in their capacity as shareholders.

More broadly, the discontinuities in the present-law employment tax treatment of general partners, limited partners, LLC members, and S corporation shareholders cause taxpayers' choice-of-business form decisions to be motivated by a desire to avoid or reduce employment tax, rather than by non-tax considerations.

Under the proposal, all partners – including general partners, limited partners, and LLC members taxed as partners – are subject to self-employment tax on their distributive share (whether or not distributed) of partnership income or loss. As under present law, specified types of income or loss are excluded from net earnings from self-employment of a partner, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service partnership, all of the partner's net income from the partnership is treated as net earnings from self-employment. If, however, any partner does not materially participate in the trade or business of the partnership, a special rule provides that only the partner's reasonable compensation from the partnership is treated as net earnings from self-employment.

Under the proposal, for purposes of employment tax, an S corporation is treated as a partnership and any shareholders of the S corporation are treated as general partners. Thus, S corporation shareholders are subject to self-employment tax under the same rules described above for partners.

IV. PENSIONS AND EMPLOYEE BENEFITS

A. Conform Definition of Qualified Medical Expenses (secs. 105, 106, 213, 220, and 223)

Under present law, prescription medicines (and insulin) are deductible under the rules relating to itemized medical expenses; over-the-counter medicines are not. However, individuals who work for an employer that has a health reimbursement arrangement or individuals who have a health savings account may purchase nonprescription medicines, such as aspirin and cough syrup, on a tax-favored basis. Under the proposal, with respect to medicines, the definition of medical expense for purposes of employer plans and health savings accounts would be conformed to the definition for purposes of the itemized deduction for medical expenses. Thus, for example, under the proposal, the cost of nonprescription medicines could not be reimbursed through a flexible spending arrangement. The proposal would provide greater equity in the tax treatment of medical expenses and would also eliminate a tax subsidy for what may be viewed as routine personal expenses.

B. Limit Deduction for Personal Use of Company Aircraft and Other Entertainment Expenses (sec. 274(e))

Section 274 disallows deductions for certain entertainment expenses. The deduction disallowance rule does not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and wages to an employee (or includible in gross income of a recipient who is not an employee).

In the context of an employer providing an aircraft to employees for nonbusiness (e.g., vacation) flights, the exception for expenses treated as compensation was interpreted by the Tax Court in *Sutherland Lumber-Southwest, Inc. v. Commissioner* (“*Sutherland Lumber*”) as not limiting the company’s deduction for operation of the aircraft to the amount of compensation reportable to its employees. This can result in a deduction many times larger than the amount required to be included in income. The American Jobs Creation Act of 2004 overturned *Sutherland Lumber*, but only with respect to covered employees.⁶

Permitting a business to deduct entertainment benefits provided to its employees in an amount greater than the compensation reportable to such employees effectively allows taxpayers to deduct personal expenses, contrary to general income tax principles. Congress curbed this practice in the American Jobs Creation Act of 2004, but only with respect to covered employees. The same rule applicable to all individuals would prevent the outcome more broadly and would simplify the law, thereby removing a potential source of noncompliance.

⁶ Covered employees are individuals who, with respect to an employer or other service recipient, are subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient were an issuer of equity securities referred to in section 16(a). Such individuals generally include officers (as defined by section 16(a)), directors, and 10-percent-or-greater owners of private and publicly-held companies.

Under the proposal, in the case of all individuals, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income. The proposal overturns *Sutherland Lumber* for all individuals.

**C. Limit Deduction for Income Attributable to Property Transferred
in Connection with the Performance of Services
to Amount Included in Income by the Service Provider (sec. 83)**

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. Under section 83, a deduction is allowed to the person for whom services are performed (the “service recipient”) equal to the amount “included” in the service provider’s gross income. Treasury regulations provide for a deduction by the service recipient equal to the amount included as compensation in the service provider’s gross income. The preamble to the regulations states that the “amount included” in gross income means the amount reported on an original or amended return or included in gross income as a result of an IRS audit of the service provider. The regulations also provide a special rule (sometimes referred to as a safe harbor), under which the service provider is deemed to have included an amount as compensation in gross income if the service recipient satisfies the reporting requirements with respect to that amount (i.e., the amount is reported on a Form W-2 or 1099 issued to the service provider).

In *Robinson v. United States*, the U.S. Court of Appeals for the Federal Circuit rejected the IRS interpretation that “included” means actual inclusion on the service provider’s tax return. The court instead interpreted “included” to mean the amount included in gross income as a matter of law (that is, the amount legally required to be included in the service provider’s gross income under section 83), without regard to the amount, if any, actually included on the service provider’s return or timely reported as compensation for services.

The amount of the deduction to which a service recipient is entitled as a result of a transfer of property in connection with the performance of services should be the amount actually included in the service provider’s income. This link helps to avoid mismatches in the amount of income and deductions attributable to such transfers. The elimination of this link under the *Robinson* decision increases the potential for such mismatches, thus creating tax administration and compliance issues.

The proposal overrides the *Robinson* decision and reaffirms that the amount of the deduction allowed with respect to a transfer of property in connection with the performance of services is determined by reference to the amount actually included in income by the service provider under section 83. The proposal also retains the safe harbor provided in Treasury regulations for an amount that is properly reported by the service recipient.

**D. Payments in Redemption of Stock Held by an ESOP Not Deductible
as Dividends (sec. 404(k))**

In general, a corporation may not deduct dividends paid to shareholders. Under section 404(k), a corporation generally may, however, deduct the amount of “applicable dividends” paid

in cash by the corporation with respect to applicable employer securities held by an employee stock ownership plan (“ESOP”). The dividend deduction is in addition to otherwise allowable deductions for contributions to the ESOP.

Some taxpayers have taken the position that payments in redemption of stock allocated to participants’ accounts under an ESOP and paid to a terminating or retiring participant in partial or full satisfaction of the plan’s obligations to pay benefits are deductible as dividends under section 404(k). The IRS issued a ruling on this issue in 2001, and held that such payments are not applicable dividends under section 404(k). However, the Court of Appeals for the Ninth Circuit in *Boise Cascade v. United States* held that such payments in redemption of the stock were deductible dividends under section 404(k).

Redemption payments like those involved in *Boise Cascade* are not the economic equivalent of a dividend. To allow a deduction for such payments would allow an employer a deduction for a transaction which is not a dividend and therefore was not intended to qualify for deduction. Further, allowing a deduction for these types of redemption payments would circumvent the deduction limitations applicable to ESOPs and could have an adverse impact on plan participants because they would lose substantial rights, such as the ability to make a tax-free rollover.

Under the proposal, redemption payments that are not economically equivalent to a dividend are not deductible under section 404(k). This result is accomplished by providing that, for purposes of determining whether an amount is deductible as a dividend under section 404(k), each ESOP participant is treated as the direct owner of any shares allocated to his or her account.

E. Provide Greater Conformity for Section 403(b) and Section 401(k) Plans (secs. 402(g), 403(b), and 415(c)(3))

Present law permits tax-deferred savings through salary reduction under certain employer-sponsored retirement plans, including qualified cash or deferred arrangements (“section 401(k) plans”) and tax-sheltered annuity plans (“section 403(b) plans”). Taxable employers are entitled to a current deduction for salary reduction contributions, while employees who make salary reduction contributions generally do not include such contributions or the earnings on the contributions in gross income until such amounts are distributed. Permitting employees to make tax-deferred contributions is intended to encourage retirement income savings.

Although many of the rules for section 401(k) and 403(b) plans have been conformed over time, special rules for section 403(b) plans still exist under present law. Present law rules for section 403(b) plans relating to the definition of includible compensation, additional elective deferrals, and nondiscrimination requirements are inequitable and create complexity in many cases. The proposal provides greater conformity of the rules for section 401(k) and section 403(b) plans by eliminating these special rules and applying the rules relating to section 401(k) plans.⁷

⁷ Under the proposal, the definition of compensation applicable to section 403(b) plans for purposes of the limit on annual additions is conformed to the definition of compensation applicable to

F. Extend Early Withdrawal Tax to Eligible Deferred Compensation Plans of State and Local Governments (sec. 72(t))

Present law imposes a 10-percent early withdrawal tax on distributions from qualified pension plans and similar tax-favored retirement savings vehicles. Subject to certain exceptions, the tax applies to withdrawals before age 59½ (55 in the case of certain retirement distributions), death, or disability. The early withdrawal tax discourages early withdrawals of amounts that are intended as retirement savings and also recaptures a measure of the tax benefits that have been provided. Governmental section 457 plans provide benefits similar to those provided under qualified retirement plans (e.g., the benefits are set aside in a funded trust for the exclusive benefit of plan participants), but the early withdrawal tax does not apply to such plans. The proposal extends the early withdrawal tax applicable to qualified retirement plans to governmental section 457 plans. The proposal would provide greater equity between the rules applicable to governmental section 457 plans and the qualified plans.

G. Modify Prohibited Transaction Rules for Individual Retirement Arrangements (“IRAs”) to Reduce Tax Shelter Transactions (sec. 4975)

Under present law, some taxpayers have used IRAs, particularly Roth IRAs, to engage in tax shelters which avoid the limitations on IRA contributions and inappropriately shelter income. These tax shelters artificially shift taxable income away from the IRA owner or from an entity controlled by the IRA owner to the IRA, a tax-exempt entity. In 2004, the Treasury Department identified certain of such transactions as listed transactions.

Present law prohibits various self-dealing transactions between certain tax-preferred retirement plans, including IRAs, and disqualified persons. The proposal is designed to restrict the ability of IRAs to be used in shelter transactions by expanding the definition of disqualified persons. Under the proposal, all IRA owners and entities established by an IRA owner are disqualified persons.

H. Repeal Pick-Up Rules for Employee Contributions to State or Local Governmental Retirement Plans (sec. 414(h))

Employer contributions to a qualified retirement plan are not includible in an employee’s income at the time of contribution and are not wages for purposes of FICA taxes. Employee contributions to a defined benefit pension plan are made on an after-tax basis, that is, they are included in income at the time of contribution. Employee contributions are also subject to FICA taxes.

defined contribution plans generally, including section 401(k) plans. The special rule permitting contributions to a section 403(b) plan for an employee for up to five years after termination of employment is eliminated. The proposal eliminates the special rule for section 403(b) plans which permits employees who have completed 15 years of service with certain employers to make additional elective deferrals. The proposal applies the actual deferral percentage test to elective deferrals under section 403(b) plans. As under present law, State and local government employers are not subject to the actual deferral percentage test under the proposal.

Under a special rule, in the case of a plan maintained by a State or local government, if contributions are designated as employee contributions, but the State or local governmental employer “picks up” (i.e., pays) the contributions, contributions so picked up (“pick-up contributions”) are treated as employer contributions. As a result of being treated as employer contributions, pick-up contributions are not includible in employees’ income at the time of contribution. In addition, pick-up contributions are generally exempt from FICA taxes unless made pursuant to a salary reduction agreement.

The pick-up rules result in inconsistent tax treatment of employee contributions to qualified retirement plans. Employee contributions made to plans maintained by private employers or by the Federal government are includible in income. However, the pickup rules allow employee contributions to State and local governmental plans to be made on a pre-tax basis. In many cases, inconsistent treatment applies also for FICA tax purposes. These inconsistencies cause inequity in the tax system.

The proposal repeals the pick-up rules. Accordingly, contributions to a State or local government plan that are designated as employee contributions under the plan are treated as employee contributions for Federal tax purposes. Thus, such contributions are includible in income and are wages for FICA purposes.

V. CORPORATE AND PARTNERSHIP PROVISIONS

A. Modify Extraordinary Dividend Rules for Common Stock (sec. 1059)

Present law contains rules requiring the basis of stock to be reduced by the portion of certain “extraordinary” dividends that is not taxed due to the dividends received deduction for portfolio and certain other corporate shareholders. Present law is intended to prevent “dividend stripping” transactions. In such transactions, a taxpayer purchases stock prior to a very large dividend for a price that reflects the expectation of the dividend, receives the dividend, and then sells the stock for a loss, at a price that reflects the reduction in value following the payment. If the dividend is taxed at a rate lower than the rate imposed on income that can be sheltered by the loss, and if the basis of stock is not reduced by any portion of the dividend received, tax benefit can result without any true economic loss to the taxpayer.

Generally, among other requirements, a quarterly common stock dividend is an “extraordinary dividend” if it exceeds 10 percent of the taxpayer’s adjusted basis for the stock (or, if greater, fair market value of the stock that can be proven to the satisfaction of the Treasury). The threshold for preferred stock dividends is five percent.

The proposal reduces the threshold for common stock extraordinary dividends from 10 percent to five percent of the taxpayer’s adjusted basis (or, if greater, fair market value of the stock that can be proven to the satisfaction of the Treasury). The proposal addresses the fact that some very large dividends can still result in dividend stripping transactions under present law.

B. Reduce Tax-Indifferent Shareholder’s Basis in Stock by Nontaxed Portion of Extraordinary Dividend (sec. 1059)

The existing extraordinary dividend rules (described above) require basis reduction if a dividend payment subject to those rules is not taxed in full because of the dividends received deduction. Thus, for example, if a corporation buys stock for \$100 and shortly thereafter receives a \$10 dividend on that stock for which a 70-percent dividends received deduction is allowed, the corporation is required to reduce its basis in the stock by an amount equal to the untaxed portion of the dividend (\$7). The intent of these rules is to prevent the taxation of a dividend at a low rate with a corresponding capital loss allowable at a higher rate.

This basis reduction rule does not apply if a dividend payment is partly or entirely exempt from U.S. taxation for reasons other than the dividends received deduction. Consequently, in certain redemptions that are treated as dividends but are not subject to full U.S. taxation, tax basis is preserved and may under present law be shifted to a shareholder whose stock is not redeemed. This shifting of basis may be from a tax-indifferent shareholder – a foreign person or tax-exempt organization – to a taxable shareholder. If the shift is to a taxable shareholder, that shareholder can use the additional basis to generate a tax loss on a subsequent disposition of the stock to which the basis has been shifted. Thus, the combination of failing to reduce basis by the nontaxed portion of an extraordinary dividend and the shifting of tax basis to a taxable person creates a taxable loss without corresponding taxable income. This result is contrary to the outcome intended by the extraordinary dividend rules.

The proposal extends the basis reduction rule described above to transactions in which extraordinary dividends (including certain redemptions treated as extraordinary dividends) are received by shareholders not subject to full, current U.S. taxation.

**C. Modify Active Business and Control Requirements for Section 355
Corporate Divisions (sec. 355)**

The original purpose of the section 355 rules that allow a corporation to “spin off” a subsidiary to shareholders without tax was to permit existing shareholders to separate existing businesses for good business purposes without immediate tax consequences. The rules generally require each separated corporation to contain at least one active trade or business held for at least five years and require the distributed corporation to be controlled by the distributing corporation under a specified equity relationship prior to the spin-off.

The proposal confines section 355 more closely to this purpose by limiting its use in the case of transactions that give shareholders an interest in a separate corporation that has more than 50 percent cash or other assets that are not qualifying 5-year active business assets, and by requiring a higher standard of continuing participating equity ownership by the same shareholders.

**D. Modify Application of Unrelated Business Income Tax to S Corporation
Shareholders (sec. 512)**

The S corporation rules were designed to require that all income of an S corporation be subject to tax at the shareholder level. This purpose should be carried out by making sure that all S corporation shareholders, including tax-exempt entities, pay tax on their share of income from the S corporation.

Under the proposal, a tax-exempt entity (other than a qualified employee stock ownership plan) is a permissible shareholder of an S corporation only if it is subject to tax on its share of S corporation income.

**E. Modify Safe Harbor for Allocation of Partnership Nonrecourse Deductions
and Exclude Nonrecourse Liabilities From Outside Basis
(secs. 704 and 752)**

Present law with respect to the allocation of partnership nonrecourse deductions is ineffective in requiring partners to allocate nonrecourse deductions in a manner consistent with their overall economic arrangement. This issue has become more serious as a result of the dramatic increase in the use of LLCs which has occurred since the nonrecourse deduction rules were originally promulgated. Partners have significant flexibility to allocate nonrecourse deductions in a tax-motivated manner which is inconsistent with their overall economic arrangement. Because the allocation of nonrecourse deductions is generally free of any non-tax economic consequences, partnerships may use such allocations to shift taxable income from one partner to another in a manner which reduces the tax liability of the partners in the aggregate.

The proposal modifies the present-law safe harbor requirement that allocations must be reasonably consistent with the allocation of some other significant item. Under the proposal, the

allocation of nonrecourse deductions must bear some relationship to the partners' overall economic arrangement rather than merely to one specific partnership item.⁸

In addition to the safe harbor modification, the proposal provides that nonrecourse liabilities of the partnership are excluded from a partner's outside basis. As a result, a partner's outside basis is increased only by contributions of money or property, distributive shares of income, gain, and tax-exempt income, and a portion of any recourse liability of the partnership.

F. Modify Adjustment Rules for Basis of Undistributed Partnership Property (sec. 734)

Present law provides that the basis of partnership property is to be adjusted as the result of a distribution of property if the partnership has so elected, or if there is a substantial basis reduction with respect to the property distributed (i.e., a basis reduction in excess of \$250,000). The purpose of the basis adjustment is to ensure that the proper amount of partnership gain or loss not recognized in the transaction shall remain with the partnership following the distribution. However, the measurement of the basis adjustment is inaccurate in some cases under present law. The proposal corrects this error by making the basis adjustment reflect the difference between the basis to the partnership of the distributed property and the reduction which occurs in the distributee partner's proportionate share of the adjusted basis of the partnership property.

G. Treat Guaranteed Payments to Partners as Payments to Nonpartners (sec. 707)

Under present law, if a partner receives a payment that is determined without regard to the income of the partnership, the payment is considered a guaranteed payment rather than a distributive share of partnership income. Another present-law rule provides that a partner who engages in a transaction with a partnership, other than in its capacity as a partner, is treated as if it was not a member of the partnership with respect to the transaction.

The statutory distinction between guaranteed payments and nonpartner payments has little continuing purpose. Eliminating the distinction would conform the income and deduction timing rules applicable to all payments to partners that are not based on partnership net income to the more generally applicable timing rules applicable to other taxpayers, would eliminate opportunities for manipulation of the tax rules, and would provide simplification benefits.

⁸ Specifically, under the new safe harbor, if the aggregate capital account balances and recourse liabilities of the partnership constitute at least 20 percent of the total capitalization of the partnership at the time the nonrecourse liability arises (using book values), then the partners may allocate nonrecourse deductions in accordance with the relative capital account balances of the partners. Alternatively, if there is a reasonable expectation of significant residual (or catchall) profits, then the partners may allocate the nonrecourse deductions in accordance with the residual profit sharing arrangement of the partners. In addition, any allocation arrangement which falls between relative capital account percentages and residual profit sharing percentages is acceptable if the required minimum capitalization and residual profit sharing expectation are both met.

Under the proposal, all compensation for services or use of capital that is not based on the net income (or an item of net income) of the partnership is treated as arising from a transaction between a partnership and a nonpartner. The income and deduction timing rule for guaranteed payments is repealed and such payments are subject to the income and deduction timing rules for nonpartner payments.

VI. INTERNATIONAL PROVISIONS

A. Amend the Employer-Provided Housing Exclusion and Impose a Stacking Rule with Respect to Non-Excludable Income (sec. 911)

Present law may allow an individual working abroad to exclude significant amounts of housing benefits. The employer-provided housing exclusion is equal to the excess of an individual's housing expenses over a base amount, but substantial amounts above the base may be excluded from income because the exclusion is limited to "reasonable housing expenses," which allows for generous interpretation by the taxpayer.

The proposal establishes an objective cap to determine "reasonable housing expenses." The Department of Housing and Urban Development ("HUD") considers maximum affordable housing to be 30 percent of an individual's annual income. The proposal also ties the employer-provided housing exclusion to the foreign earned income cap (\$80,000) to bring the two exclusions into conformity. With these two modifications, the objective cap on employer-provided housing is set at 30 percent of \$80,000.

Present law may also allow individuals working abroad to benefit from being subject to low income tax rates on their non-excludable income. The taxable income of section 911 beneficiaries is subject to rates that ordinarily are applicable to taxpayers with substantially less economic income.

The proposal imposes a stacking rule that requires individuals with section 911 benefits to stack their taxable income after their section 911 exclusion amounts, thereby subjecting such individuals to the same rates applicable to individuals living and working in the United States earning the same amount of economic income.

B. Amend Rules for Determining Corporate Residency (sec. 7701)

Present law provides that a corporation is treated as foreign for U.S. tax purposes if it is incorporated in a foreign jurisdiction. This is true even where all of a corporation's management activities, employees, business assets, operations, and revenue sources are located in the United States. Thus, the present-law test for determining corporate residency is artificial and allows certain foreign corporations that are economically similar or identical to U.S. corporations to avoid being taxed like U.S. corporations.

For publicly traded foreign-incorporated entities, the proposal adds new rules that look to a corporation's primary place of management and control. A corporation's primary place of management and control is where the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries). If a company is incorporated in the United States, it is still considered a domestic corporation and does not have to look any further to determine its residence.

C. Modify Entity Classification Rules to Reduce Opportunities for Tax Avoidance (sec. 7701)

In order to apply the various substantive rules of the Code to transactions involving business entities, the entities first must be classified, typically as corporations, partnerships, or branches. The classification of a business entity carries significant Federal tax consequences. For example, corporations generally are subject to tax at the entity level, whereas partnerships and branches generally are not. Transactions between a branch and its owner generally are disregarded for Federal tax purposes (including the anti-deferral rules of subpart F), subject to several exceptions. Since 1997, new entity classification regulations have been in effect that generally allow taxpayers simply to elect the desired classification for many types of entities, including certain limited-liability entities that are available under the laws of many foreign jurisdictions. These regulations are commonly referred to as the “check the box” regulations. It has been widely observed that the “check the box” regulations, while producing some simplification benefits with respect to both domestic and foreign entities, also have created some unintended tax-avoidance opportunities as applied to foreign entities. In particular, it appears that the availability of single-member disregarded entities has rendered it easy in many cases to avoid current taxation under subpart F.

The proposal strikes a balance between the goal of simplification and the policies reflected in the substantive provisions of the Code by generally retaining the elective approach of the current entity classification regulations, but providing that single-member business entities organized under foreign law must be treated as corporations for Federal tax purposes. This approach will not prevent every arrangement that might be thought to be abusive, as not all abuses require the use of a separate disregarded entity, but the approach will render it considerably more difficult in many cases for taxpayers to use the entity classification rules to frustrate the intent of the international tax provisions of the Code. A wide range of potentially abusive transactions that are currently disregarded for purposes of the substantive rules of the Code would be “regarded” under the proposal, thereby providing a greater opportunity to apply and adjust those rules in an appropriate manner, whether that be to allow or to disallow a particular tax result.

D. Adopt a Dividend Exemption System for Foreign Business Income

It has long been recognized that the worldwide, deferral-based system of present law distorts business decisions in a number of ways. By establishing repatriation as the system’s principal taxable event, the worldwide, deferral-based system creates incentives in many cases to redeploy foreign earnings abroad instead of in the United States, thereby distorting corporate cash-management and financing decisions.

At the same time, basing the system on repatriation renders the payment of U.S. tax on foreign-source business income substantially elective in many cases, because repatriation itself is elective. By maintaining deferral indefinitely, a taxpayer may achieve a result that is economically equivalent to 100-percent exemption of income, with no corresponding disallowance of expenses allocable to the exempt income, provided that the taxpayer does not repatriate the earnings or run afoul of subpart F or other anti-deferral rules. In addition, taxpayers that repatriate high-tax earnings may be able to use excess foreign tax credits arising

from these repatriations to offset the U.S. tax on lower-tax items of foreign-source income, such as royalties received for the use of intangible property in a low-tax country. For these reasons, in many cases, the present-law “worldwide” system actually may yield results that are more favorable to the taxpayer than the results available in similar circumstances under the “territorial” exemption systems used by many U.S. trading partners. These systems generally fully tax foreign-source royalties and portfolio-type income, and often exempt less than 100 percent of a dividend received from a subsidiary, as a proxy for disallowing expenses allocable to the exempt income. At the same time, however, the potential for taxation under the U.S. system by reason of either repatriation or application of the highly complex U.S. anti-deferral rules arguably forces U.S.-based multinationals to contend with a greater degree of complexity, and to engage in a greater degree of tax-distorted business planning, than many of their foreign-based counterparts resident in countries with exemption systems. The proposal would replace the current worldwide, deferral-based system with a dividend exemption system to mitigate many of these remaining problems, while generally moving the system further in the direction charted by the Congress in 2004.

VII. OTHER BUSINESS PROVISIONS

A. Disallow Deduction for Interest on Indebtedness Allocable to Tax-Exempt Obligations (sec. 265)

Present law disallows a deduction for interest on indebtedness incurred to buy or hold tax-exempt bonds. Under IRS rules for taxpayers other than financial institutions, this interest disallowance rule applies only if borrowing can be traced to the purchase or ownership of tax-exempt bonds (the “tracing rule”). Under these IRS rules, moreover, the interest disallowance rule generally does not apply if a taxpayer’s tax-exempt obligations represent two percent or less, by average adjusted basis, of the taxpayer’s aggregate trade or business assets. By contrast, a financial institution generally is denied a deduction for the portion of its interest expense that equals the ratio of the financial institution’s basis in its tax-exempt obligations to its basis in all its assets (the “pro rata rule”), and the two-percent safe harbor does not apply.

Unlike the pro rata rule, the tracing rule requires an inquiry into a taxpayer’s intent in borrowing. A taxpayer’s deduction for the interest expense of borrowing is subject to the tracing rule only if the taxpayer intends to use the proceeds of the borrowing to buy or hold tax-exempt obligations. Because intent is difficult to determine, and because a firm’s funds are fungible, the tracing rule has proven difficult to administer and easy to avoid. In particular, related corporations have avoided the tracing rule by engaging in borrowing through one corporation and the holding of exempt obligations by another corporation. Moreover, the two-percent safe harbor permits a certain amount of tax arbitrage.

The proposal extends to all corporations (other than insurance companies) the pro rata rule applicable to financial institutions under present law. Accordingly, the proposal generally repeals the tracing rule, and it repeals the two-percent safe harbor. Moreover, to restrict taxpayers’ ability to avoid interest disallowance through the use of related parties, the proposal treats all members of the same affiliated group as one taxpayer and treats any interest in a partnership held by a taxpayer as that taxpayer’s direct ownership interest in its allocable share of partnership assets and liabilities.

B. Modify Recapture of Section 197 Amortization (sec. 1245)

Under present law, it is difficult for the IRS to ensure that taxpayers recognize the appropriate amount of ordinary income recapture when multiple intangible assets are sold as part of a single transaction. Because ordinary income is recaptured only to the extent of ordinary deductions previously claimed with respect to each individual asset, taxpayers have an incentive to allocate less of the sales proceeds to intangible assets with respect to which significant amortization deductions have been claimed. Congress enacted section 197 to reduce controversies between taxpayers and the IRS with respect to acquisition of intangible assets, but the potential for controversy remains with respect to the subsequent disposition of section 197 intangibles.

Under the proposal, if multiple section 197 intangibles are sold (or otherwise disposed of) in a single transaction or series of transactions, the seller must calculate recapture as if all of the section 197 intangibles were a single asset. Thus, any gain on the sale (or other disposition) of

the intangibles is recaptured as ordinary income to the extent of ordinary depreciation deductions previously claimed on any of the section 197 intangibles. The proposal applies regardless of whether the intangibles were acquired as part of the same acquisition. If the sale transaction includes an intangible asset whose adjusted basis exceeds its fair market value, such intangible is not subject to recapture and is excluded from this aggregate calculation. The loss on such intangible continues to be permitted to the extent it is permitted under present law.

C. Modify Application of Income Forecast Method of Depreciation (sec. 167)

Generally, films and television productions are among the types of property eligible for depreciation using the income forecast method. In some cases, the present-law rule relating to participations and residuals paid in connection with a film or television production allows taxpayers to deduct costs before they have been paid or incurred. This is because the basis used for calculating the income forecast deduction can differ from the property's actual adjusted basis. Taxpayers should not be permitted to deduct costs prior to the time such costs are paid or incurred, under principles that are generally applicable in determining the timing of deductions.

Under the proposal, depreciation deductions under the income forecast method would be disallowed to the extent that they would cause the adjusted basis for purposes of determining gain or loss on sale to become negative. Any disallowed deductions will effectively be carried over by operation of the income forecast formula in subsequent years.

D. Apply Luxury Automobile Limitations to Sport Utility Vehicles (sec. 280F)

Under present law, certain vehicles which contain features that are not necessary for purposes of conducting business are not subject to the luxury automobile depreciation limitations. While Congress restricted the ability of certain sport utility vehicles to qualify for the expanded expensing provisions of section 179, such vehicles remain exempt from the luxury automobile depreciation limitation if they weigh more than 6,000 pounds and are therefore accorded more favorable treatment than are luxury sedans, sport utility vehicles, and pickup trucks weighing less than 6,000 pounds. Because the luxury automobile depreciation limitation and the section 179 expensing limitation appear to have the same rationale, it is appropriate to apply the luxury automobile depreciation limitation to the class of vehicles targeted by the section 179 expensing limitation.

When the luxury automobile limits were enacted, new car sales included far fewer trucks and vans than today, and those vehicles were more likely to be used in the operation of a business. Now, nearly half of all new vehicle sales are not automobiles, and many more of the larger vehicles are purchased as personal-use vehicles than they were previously. For these reasons, it is no longer appropriate to assume that the purchase of these larger vehicles is a likely indicator of 100 percent business use. Thus, an extension of the luxury automobile limits to these larger vehicles is appropriate.

Under the proposal, all vehicles subject to either the present-law luxury automobile depreciation limitation or to the present-law section 179 expensing limitation for certain sport utility vehicles are made subject to the luxury automobile limitation.

E. Disallow Deduction for Interest on Debt Allocable to Tax-Exempt Income of Insurance Companies (secs. 265 and 832)

A 15-percent proration rule applies to property and casualty insurance companies. In calculating its deduction for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts the company owns. A separate proration rule applies to life insurance companies.

The 15-percent proration rule applicable to untaxed income of property and casualty insurance companies does not effectively limit the companies' ability to engage in tax arbitrage. Applying a rule similar to the rule for other types of financial intermediaries would improve neutrality of the tax law by treating more financial intermediaries similarly, and would more effectively limit tax arbitrage.

The proposal extends to property and casualty insurers the pro rata interest disallowance rule that applies to financial institutions under present law section 265(b). As under the present-law rules for insurers, however, the proposal applies not only with respect to tax-exempt interest, but also with respect to the untaxed portion of dividends received and insurance inside buildup. The proposal does not change the tax treatment of life insurers.

F. Eliminate Double Deduction of Mining Exploration and Development Costs Under the Minimum Tax (sec. 57)

Present law allows the double deduction of the same mining exploration and development costs in computing alternative minimum taxable income. The proposal would prevent the double deduction.

VIII. EXEMPT ORGANIZATIONS

A. Require Five-Year Review of Exempt Status of Public Charities and Private Foundations and Annual Notice by Organizations Not Required to File Information Returns (sec. 508)

Under present law, charitable organizations are required to obtain a determination from the IRS that they are tax exempt as a charitable organization, and thus eligible to receive deductible contributions. Typically, organizations apply for charitable status shortly after they are formed and the IRS generally must make its determination of such status based on statements of intent by the organization. However, once charitable status is granted, it rarely is revoked. Yet organizations may change and grow significantly over time, sometimes in ways inconsistent with their exemption. There is no mechanism in present law requiring a periodic review of the basis for an organization's charitable status.

The proposal requires that every five years, charitable organizations (other than churches) file with the IRS information that would enable the IRS to determine whether the organization continues to be organized and operated exclusively for exempt purposes. The proposal applies to new organizations and organizations receiving charitable status within ten years of enactment of the proposal. The filing would be done electronically, perhaps as a schedule to the current information return, and be made publicly available to encourage improved oversight of the sector by both the public and by State officials. The IRS would not be required to take action or make any determination with respect to a five-year review filing, but would have the discretion to review any filing and could revoke tax-exempt status retroactively or prospectively, as warranted by the facts and circumstances.

Part of this proposal also requires small charitable organizations that are exempt from the information return filing requirements to file with the IRS a short form each year to enable the IRS to maintain a record of the continuing existence of such organizations and provide the public with the ability to obtain basic information about the organization.

B. Impose Termination Tax on Conversions of Assets of Charities (secs. 501, 507, 4941, and 4958)

Related to the issue of an organization's ongoing basis for tax exemption is the effect of a public charity's dissolution, acquisition by a for-profit company, and other change of ownership or control. Federal tax law requires that upon dissolution, the charitable assets of the organization continue to be dedicated to charitable purposes. Yet there is no Federal enforcement mechanism of this requirement in the case of public charities. In contrast, upon their termination, private foundations generally are subject to a tax equal to the amount of the aggregate tax benefit received by the foundation over time (not to exceed the net asset value of the foundation), unless their assets are dedicated to charitable purposes.

In order to provide the Federal government with a means to enforce the "dedication to charity" requirement, the proposal imposes a termination tax on liquidations or conversions of a public charity. The tax would also apply to private foundation terminations, and differs from the present law termination tax principally in that the tax would be based on the net asset value of

the charity and not on the aggregate tax benefit. The tax could not be recovered against assets held by the charity for charitable purposes. The proposal also would impose the present-law excess benefit transaction rules to conversions of a public charity if, after the conversion, insiders of the public charity are also insiders of the newly converted entity. This is intended to ensure that when insiders are involved in the acquisition of a charitable organization, the acquisition is subject to the present law rules that tax abusive insider transactions.

C. Tax Involvement by Exempt Organizations in Tax-Shelter Transactions (secs. 6011 and 6707A)

One of the primary compliance concerns in tax law today is abusive tax shelters. The increasing involvement of exempt organizations as accommodation parties in tax shelter transactions is a growing concern. Such transactions contribute to the erosion of the tax base by improperly extending the benefit of tax exemption to nonexempt persons. Tax shelters involving exempt organizations also raise questions about whether the facilitation of tax avoidance by an exempt organization can be consistent with the basis for tax exemption. Although recent legislation addressed many tax shelter abuses, such legislation does not prevent certain abuses that might be perpetrated using exempt organizations.

The proposal imposes an excise tax on the participation by any exempt organization (not just charitable organizations) in a transaction that the Treasury Department determines is a listed transaction, or a reportable transaction that is a confidential transaction or one with contractual protection. Under the proposal, if an exempt organization participates in such a transaction, knowing or with reason to know that the transaction is “prohibited,” the entity is subject to a tax of 100 percent of the entity’s net income attributable to the transaction. If the exempt entity is eligible to receive deductible contributions, the Treasury Department may suspend eligibility for one year. The entity-level tax does not apply to certain pension plans and similar tax-favored accounts. An excise tax would also apply to the entity managers that approved the entity’s participation in the transaction.

The proposal also addresses the case in which an exempt organization participates in a transaction that is later determined by the Treasury Department to be a prohibited tax shelter transaction. Because the exempt entity did not know at the time it entered into the transaction that it would later be prohibited, taxing all of the entity’s net income attributable to the transaction may not be appropriate. However, the proposal would impose an excise tax at the UBIT rate on the exempt organization’s net income from the transaction after it has learned that the transaction is prohibited. There also are obligations to disclose involvement in such transactions.

D. Reform Intermediate Sanctions and Extend Certain Reforms to Private Foundations (secs. 4941 and 4958)

The intermediate sanctions regime was enacted in 1996 to provide a sanction short of revocation of tax-exemption in cases where the assets of a public charity or social welfare organization are used to benefit insiders. Since the enactment of intermediate sanctions, however, there continue to be reports of abuses by insiders and managers of public charities, as well as by private foundations. Compensation packages, loans, sales of property to insiders, and

other transactions, such as providing insiders equity opportunities in related for-profit organizations and joint ventures or in conversion transactions, increasingly are raising questions about the extent to which excess benefits are being provided to insiders of exempt organizations. Transactions with insiders create widespread opportunities for abuse, especially when the determination of whether a transaction passes muster depends upon a subjective determination of fair market value or reasonableness of compensation. Given the practical difficulties of enforcement of valuation questions, the continued reports of abuses, and the critical importance of ensuring that charitable assets are not used for private purposes, the proposal addresses specific aspects of the intermediate sanctions regime that impede enforcement and extends certain of these reforms to the self-dealing regime applicable to private foundations.

The proposal eliminates the rebuttable presumption of reasonableness contained in the intermediate sanctions regulations. The rebuttable presumption of reasonableness was intended to be an incentive for organizations to adopt procedures that, if followed, will protect against the occurrence of an excess benefit transaction. However, there appear to be no reasons to depart from normal tax rules by providing special treatment for organization managers and disqualified persons. Further, the rebuttable presumption of reasonableness may undermine the effectiveness of the intermediate sanctions regime by emphasizing process instead of substance, with the result that organization managers and insiders can use the process to reach a desired result with impunity. Under the proposal, the procedures that presently provide an organization with a presumption of reasonableness (i.e., advance approval by an authorized body, reliance upon data as to comparability, and adequate and concurrent documentation) generally will establish instead that an organization has performed the minimum standards of due diligence with respect to an arrangement or transfer involving a disqualified person. The proposal extends such minimum standards to transactions between private foundations and disqualified persons for purposes of the private foundation self-dealing rules, and imposes a tax on the organization (whether public charity, private foundation, or social welfare organization) unless it establishes that it operated consistent with the minimum standards of due diligence with respect to the transaction.

The proposal eliminates the special rule that provides that an organization manager's or foundation manager's participation ordinarily is not "knowing" for purposes of the intermediate sanctions and self-dealing excise taxes if the manager relied on professional advice. Instead of providing a special rule, reliance on professional advice that a transaction is not an excess benefit transaction generally would be a favorable factor showing that the organization manager did not know the transaction provided an excess benefit. The proposal also provides that an initial contract between an organization and a person who was not a disqualified person immediately prior to entering into the initial contract is subject to the intermediate sanctions rules if such person would become a disqualified person upon (a) entering into the contract, or (b) under the terms of the initial contract, at any time within two years of the time the contract is entered into. Allowing initial contracts to escape the scrutiny of the intermediate sanction provisions permits an organization to provide a substantial excess benefit to a third party without any real threat of a sanction to a party to the transaction or to the organization managers.

**E. Increase the Amount of Excise Taxes Imposed on Public Charities,
Social Welfare Organizations, and Private Foundations
(secs. 4941, 4942, 4943, 4944, 4945, and 4958)**

Excise tax regimes that penalize certain conduct generally are effective if there is the right combination of a punitive sanction and the threat that the sanction will be enforced. In lieu of increasing the audit rate for such organizations, the proposal increases the amount of the sanction in order to impose an additional deterrent to prohibited behavior. The amount of the excise taxes applicable to private foundations has not been changed since their introduction in 1969. In recent years, audits of foundations and other section 501(c)(3) organizations generally has fallen significantly resulting in an increased likelihood that private foundations (and other charitable organizations) are not as compliant as when the audit rate was higher, and that the current excise tax rates are not providing a sufficient deterrent.

In general, the proposal doubles the amount of initial excise taxes with respect to certain activities by private foundations (self-dealing, failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures), doubles the dollar limitation that applies to the tax on foundation managers with respect to certain of these actions, and doubles the dollar limitation on the organization managers tax for excess benefit transactions between public charities or social welfare organizations and organization insiders.

**F. Modify Charitable Deduction for Contributions of Conservation
and Facade Easements (sec. 170)**

Under present law, a charitable contribution deduction generally is not permitted for contributions of a partial interest in property. There is an exception for qualifying conservation contributions, which include easements and other partial interests in property that are for conservation purposes. Determining the value of conservation easements or similar partial interests is difficult. First, the value of the interest given away is a function of the contract terms crafted by the donor, and will vary from case to case. There may be few, if any, comparables to help determine value. Second, partial interests generally are harder to value than entire interests because of the donor's continuing interest in the contributed property. Third, in many cases, taxpayers who make these contributions are already subject to significant State and local restrictions on the use of their property. Such restrictions vary considerably from jurisdiction to jurisdiction and would have to be taken into account in valuing the interest.

Because these valuation difficulties present the greatest challenge in the case of conservation easements placed on property used by the taxpayer as a personal residence, the proposal denies a deduction for such contributions. For gifts of easements placed on other historic structures, the proposal permits a deduction equal to the lesser of 5 percent of the fair market value of the structure or 33 percent of the value of the easement. For all other gifts of conservation easements or other similar partial interests, the deduction would be limited to 33 percent of the value of the easement or interest. Moreover, the gift must be pursuant to some clearly articulated Federal, State, or local government policy in favor of the conservation objective. The proposal also imposes heightened appraisal standards and requirements in the case of these contributions.

G. Limit Charitable Deduction for Contributions of Clothing and Household Items (sec. 170)

Under present law, the deduction for charitable contributions of clothing and household items is the fair market value of such items, unless they have appreciated in value in the hands of the taxpayer. The relatively small value of any item of clothing or household goods makes it unlikely that the IRS challenges many of these deductions, leaving taxpayers with significant flexibility in valuing such gifts. Moreover, taxpayers may have a natural tendency to overvalue such items due to the attachment they have to the item. Because this situation is vulnerable to error and noncompliance, the proposal requires that at a minimum, the potential amount of error should be capped. Thus, the proposal suggests limiting the deduction for gifts of clothing and household goods to \$500. All of the current-law substantiation requirements would continue to apply in order for the deduction to be available.

H. Reform Rules for Charitable Contributions of Property (sec. 170)

Under present law, taxpayers are entitled to deduct the fair market value of most charitable contributions of capital gain property to a public charity. When property value is uncertain, this rule presents compliance burdens for the taxpayer, noncompliance opportunities, and law enforcement difficulties. Challenging taxpayer valuations is a very resource-intensive task for the IRS. Even a preliminary determination that the amount of a deduction may be questionable requires an upfront commitment of resources.

In general, for contributions of appreciated property (not including publicly traded securities, certain other property, and property that has depreciated in value, such as clothing and household items), the proposal requires that the charitable deduction be equal to the taxpayer's basis in the property. This is the present-law rule for contributions to most private foundations as well as contributions of certain property to public charities. In most cases, basis is a more certain amount than fair market value and subject to easier proof by the taxpayer and verification by the IRS. Thus, this option could be expected to improve compliance, reduce burdens and disputes, and lessen the amount of IRS enforcement effort. It would also eliminate the greater tax preference under current law provided to these types of property gifts than to contributions of cash. As an alternative, the proposal suggests that a basis deduction might apply only to taxpayers contributing property unrelated to the charity's exempt function. Under this alternative, for example, a taxpayer could still deduct the fair market value of an appreciated gemstone given to a natural history museum, but could deduct only the basis of appreciated closely held company stock or real estate contributed to the museum.

I. Require Public Disclosure of Form 990-T and Related Certification Requirements (secs. 6104 and 6685)

Although exempt organizations are required to file their unrelated business income tax returns with the IRS, the public does not have access to information pertaining to an organization's unrelated business activities that is included in the IRS returns. Public disclosure of nonproprietary trade or business information would provide the public an opportunity to review the extent and type of unrelated business activities an organization conducts, enabling the public to assess all of the activities being conducted by organizations it supports through tax-

deductible charitable contributions or through the tax exemption. In addition, more complete and accurate reporting of unrelated business activities conducted by large organizations would be improved by requiring independent auditors or counsel to make certain certifications regarding their review of such organizations' unrelated and other activities.

The proposal extends the present-law public inspection and disclosure requirements and penalties applicable to the information return to an organization's unrelated business income tax return. The proposal provides that certain information may be withheld by the organization from public disclosure and inspection if public availability would adversely affect the organization. In addition, the proposal requires that organizations that normally have annual total gross revenues or gross assets of at least \$10 million must include with its information and unrelated business income return filings a certification by an independent auditor or by independent counsel that the organization's filings accurately reflect the unrelated business income tax liability of the organization for the taxable year. The certifying auditor or counsel must also attest to whether it has knowledge regarding whether the organization has participated in or derived income from certain tax shelter transactions.

J. Expand the Base of the Tax on Private Foundation Net Investment Income (sec. 4940)

Case law casts doubt on the application of the tax on net investment income of private foundations. As a result, it is not clear under present law whether income from certain investments is subject to tax. The proposal clarifies the scope of the tax by amending the definition of gross investment income to include certain items of income not presently enumerated in the Code but identified in Treasury regulations, namely, income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments. In addition, the capital gains and losses subject to the tax are modified to include capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used to further an exempt purpose. By broadening the definition of gross investment income, the proposal protects the tax base by providing certainty for taxpayers and administrators that income from annuities, notional principal contracts, and other substantially similar income from ordinary and routine investments are subject to the tax. Extending the tax to include all capital gain through appreciation produces neutrality in the treatment of investment assets.

K. Limit Tax-Exempt Status of Fraternal Beneficiary Societies that Provide Commercial-Type Insurance (sec. 501(c)(8))

Fraternal beneficiary societies that provide insurance are engaged in an activity whose nature and scope is inherently commercial rather than fraternal in nature. Congress has recognized that providing commercial-type insurance is a commercial business activity, and that granting tax-exempt status for organizations that engage in insurance activities gives an unfair competitive advantage to these organizations. Therefore, tax-exempt status is not appropriate for an organization unless no substantial part of its activities consist of providing commercial-type insurance. This is especially the case when the rationale for providing the exemption for an organization (i.e., that the organization provides benefits exclusively to members that share a

common, fraternal bond) has been eroded, and fraternal features are incidental to the insurance activity such that the organization is indistinguishable from a taxable insurance company.

Under the proposal, a fraternal beneficiary society, order, or association is exempt from tax as an organization described in section 501(c)(8) only if no substantial part of its activities consists of providing commercial-type insurance. For this purpose, no substantial part has the same meaning as under the present-law rule, and commercial-type insurance generally is any insurance of a type provided by insurance companies (including annuities). An organization that is treated as not exempt from tax under the proposal is subject to tax as if it were an insurance company, including with respect to its fraternal and other activities. In the case of an organization that is exempt from tax under the proposal, the activity of providing commercial-type insurance is treated as an unrelated trade or business, but is taxed under the rules relating to insurance companies with respect to such activity, rather than under the unrelated business income tax rules generally applicable to exempt organizations.

L. Establish Additional Exemption Standards for Credit Counseling Organizations (secs. 501(c)(3) and 501(c)(4))

An entire industry of credit counseling, credit repair, and debt management and debt consolidation has emerged over the past 30 years, with much of this activity conducted by nonprofit organizations that initially received favorable exempt status determinations from the IRS. During this period, judicial decisions relaxed exemption standards for credit counseling organizations claiming exempt status, ultimately resulting in many organizations conducting substantial activities that are not directly related to the charitable and educational purposes that initially formed the rationale for providing exemption from Federal income tax. Activities such as debt management plan and credit repair services test, and in many instances cross, the boundaries of what should be permissible activity for a charitable, educational, or social welfare organization. Legislation to establish exemption standards tailored to the peculiar aspects of the industry would provide greater certainty that further erosion of exemption standards does not occur, and strengthen enforcement of Federal and State consumer protection laws by limiting exemption from those laws to those organizations that satisfy stricter tax-exemption standards.

Under the proposal, a nonprofit credit counseling agency or other nonprofit organization that provides credit counseling, debt management, and similar services, is eligible for exemption from income tax only as a charitable or educational organization under section 501(c)(3), or as a social welfare organization under section 501(c)(4), and only if certain requirements are satisfied. In general, such requirements relate to an organization's primary activities, loan practices, fee arrangements, level and type of debt management plan activity, board of directors, referral policies, affiliations, and the solicitation of voluntary contributions.

IX. TAX-EXEMPT BOND PROVISIONS

A. Impose Loan and Redemption Requirements on Pooled Financing Bonds (sec. 149)

Gross income generally does not include interest received on State or local bonds. At times, State or local bonds are issued to provide financing for the benefit of a third party (a “conduit borrower”). Pooled financing bonds are issues in which the proceeds are used to make or finance loans to two or more conduit borrowers, unless the conduit loans are to be used to finance a single project.⁹ A pooled financing bond is not tax-exempt unless the issuer reasonably expects that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue.

A number of pooled financing bonds have been issued recently under which few or no loans were made to conduit borrowers from bond proceeds. A common feature of these transactions is the use of non-binding demand surveys that fail to adequately identify potential borrowers or evaluate current financing needs. Many of these transactions involve large issuances by small local governments that receive a fee to act as the issuer of the pooled financing. These transactions result in greater issuance of tax-exempt bonds than necessary to finance current governmental activities, diminishing the utility and value of the tax subsidy.

The proposal imposes new requirements on pooled financing bonds as a condition of tax-exemption. First, the proposal imposes a written loan commitment requirement to restrict the issuance of pooled bonds where potential borrowers have not been identified (“blind pools”). Second, in addition to the current three-year expectations requirement, the issuer must reasonably expect that at least 50 percent of the net proceeds of the pooled bond will be lent to borrowers one year after the date of issue. Third, the proposal requires the redemption of outstanding bonds with proceeds that are not loaned to borrowers within the expected loan origination periods. Finally, the proposal eliminates a special rule allowing an issuer of pooled financing bonds to disregard the pooled bonds for purposes of determining whether the issuer qualifies for the small issuer exception to arbitrage rebate.

B. Amend Information Reporting Requirements to Include Interest on Tax-Exempt Bonds (sec. 6049)

Generally, gross income does not include interest on State or local bonds. However, the amount of interest received on tax-exempt bonds is pertinent to a number of tax determinations, including minimum tax liability, taxable Social Security benefits, and eligibility for the earned income credit. In addition, taxpayers are required to report the amount of tax-exempt interest received during the taxable year.¹⁰ Issuers of tax-exempt bonds, however, are not required to file information returns identifying the recipients of interest payments. The lack of a reporting requirement for interest payments on tax-exempt bonds may lead to incorrect reporting and erroneous calculations of tax liability by individual taxpayers.

⁹ Treas. Reg. sec. 1.150-1(b).

¹⁰ Sec. 6012(d).

Under the proposal, issuers of tax-exempt bonds are required to file information returns identifying the amount of interest payments in a calendar year and the name, address, and TIN of the person to whom interest is paid. The recordkeeping requirement imposed on issuers as persons required to file information returns may be satisfied by contracting with a third party to maintain the necessary information at the time bonds are issued.

C. Clarify Limitations on Indian Tribes' Use of Tax-Exempt Bond Proceeds (sec. 7871)

Although not States or subdivisions of States, Indian tribal governments are provided with a tax status similar to State and local governments for specified purposes under the Code.¹¹ Among the purposes for which a tribal government is treated as a State is the issuance of tax-exempt bonds. However, bonds issued by tribal governments are subject to limitations not imposed on State and local government issuers. Tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions or certain manufacturing facilities.¹²

Despite the limitations on bonds issued by Tribal governments, there have been reports of transactions in which State or local governments issued tax-exempt bonds and loaned the proceeds to Indian tribes to finance the construction of casino-related facilities. It has been argued that bonds issued in connection with these transactions are tax-exempt because the restrictions on bonds financing the activities of tribal governments do not apply where the tribe is the borrower of bond proceeds rather than the direct issuer.

Under the proposal, section 7871, which allows Indian tribes to finance projects with tax-exempt bonds subject to certain limitations, is amended to clarify that it applies whether an Indian tribal government is a conduit borrower or an issuer of tax-exempt bonds. The proposal has no impact on the ability of Indian tribes to enter into legitimate borrowing transactions with States or local governments. Rather, the proposal clarifies the intent of Congress and provides that Indian tribes must use the proceeds of tax-exempt bonds in the same manner whether they are direct issuers of such bonds or conduit borrowers.

D. Eliminate Private Payment Test for Stadium Bonds (sec. 141)

Gross income generally does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or are primarily repaid with governmental funds. Private activity bonds are bonds in which States or local governments provide financing to nongovernmental persons (e.g., private businesses or individuals). The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test (“the private business test”); or (2) “the private loan financing test.”

¹¹ Sec. 7871.

¹² Sec. 7871(c).

In 1986, Congress eliminated a provision expressly allowing tax-exempt financing for sports facilities. Nevertheless, professional sports facilities continue to be financed with tax-exempt bonds despite the fact that privately owned sports teams are the primary (if not exclusive) users of such facilities. This is because present law permits the use of tax-exempt bond proceeds for private activities if either part of the two-part private business test is not met. In the case of bond-financed professional sports facilities, issuers have intentionally structured the tax-exempt bond issuance and related transactions to fail the private payment test. In most of these transactions, the professional sports team is not required to pay for more than a small portion of its use of the sports facility. As a result, the private payment test is not met and the bonds financing the facility are not treated as private activity bonds, despite the existence of substantial private business use.

The proposal eliminates the private payment test for professional sports facilities. Under the proposal, bonds issued to finance a professional sports facility are taxable private activity bonds if more than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit, regardless of the amount of private payments received with respect to such use. A professional sports facility is defined as real property or related improvements used, in whole or in part, for professional sports. Use for professional sports includes any use by a nongovernmental person for sports exhibitions, games, or training which generates monetary benefit.

E. Require Allocation of Volume Cap to Mortgage Credit Certificates Based on Allocation of Volume Cap to Mortgage Bonds (secs. 25 and 143)

Gross income generally does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or are primarily repaid with governmental funds. Private activity bonds are bonds in which States or local governments provide financing to nongovernmental persons (e.g., private businesses or individuals).

The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes (“qualified private activity bonds”).¹³ The definition of a qualified private activity bond includes a qualified mortgage bond.¹⁴ Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. As with most qualified private activity bonds, the aggregate volume of qualified mortgage bonds which may be issued in a State is restricted by annual volume limits (“volume cap”).

Qualified governmental units can elect to exchange all or a portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates (“MCCs”).¹⁵ MCCs

¹³ Secs. 103(b)(1) and 141.

¹⁴ Sec. 143(a).

¹⁵ Sec. 25(c)(2).

entitle homebuyers to a nonrefundable income tax credit for a specified percentage of interest paid on mortgage loans on their principal residences.

MCCs provide a more efficient and stable mechanism for delivering the tax subsidy to potential homebuyers than qualified mortgage bonds. Despite this, the program is not widely used. For example, in 2002, \$4.6 billion of qualified mortgage bonds were issued, representing about 15 percent of States' private activity bond volume, compared to \$356.2 million of MCCs, representing about one percent of 2002 private activity bond capacity. The efficiencies that may be achieved through increased use of MCCs warrant requiring issuers to dedicate a portion of bond authority to the issuance of MCCs. Therefore, the proposal requires State and local issuing authorities to dedicate at least one dollar of volume cap to MCCs for every four dollars allocated to qualified mortgage bonds.

F. Eliminate Advance Refunding of Governmental Bonds and 501(c)(3) Bonds (sec. 149(d))

Gross income generally does not include interest received on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Bonds issued to finance the activities of charitable organizations described in section 501(c)(3) ("qualified 501(c)(3) bonds") are one type of private activity bond.

A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). The Code contains different rules for "current" as opposed to advance refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond.¹⁶ Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the Code limits advance refundings. Generally, governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time.¹⁷ Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.¹⁸ The Code limits advance refunding bonds because they represent an inefficient subsidy from the Federal government to State and local governments and section 501(c)(3) organizations because they result in two or more issues of tax-exempt bonds outstanding simultaneously for the financing of a single activity. For example, if tax-exempt bonds are issued to finance a building and a second issue of tax-exempt bonds is issued to advance refund the first bonds, the Federal government bears a

¹⁶ Sec. 149(d)(5).

¹⁷ Sec. 149(d)(3).

¹⁸ Sec. 149(d)(2).

revenue loss on both issues of bonds, resulting in a double subsidy for the same building.¹⁹ Thus, the proposal eliminates advance refundings of governmental bonds and 501(c)(3) bonds.

¹⁹ This is unlike refinancing a home mortgage loan where the original loan is retired at the time of the refinancing.

X. EXCISE TAXES

A. Modify the Federal Excise Tax on Communications Services (secs. 4251-4254)

A three-percent Federal excise tax is imposed on amounts paid for communications services. Communications services are defined as “local telephone service,” “toll telephone service,” and “teletypewriter exchange service.” Due to changes in technology and commercial practice in the telecommunications industry, recent cases have placed into question whether the excise tax will continue to apply to the services to which it was intended to apply.

In addition, the proliferation of wireless communications technology and the Internet, and in particular broadband access, has blurred the lines between “data” and “voice” quality service and between the functions of transmission and application. Consequently, service providers have found it increasingly difficult to determine which services are taxable communications services and which are nontaxable information services, particularly when services are “bundled.”

The proposal contains three options. Under Option 1, the communications excise tax is imposed upon both local and toll voice telephone services, regardless of whether the charges are fixed or vary with distance, elapsed transmission time, both, or some other criteria. It is also clarified that the tax is intended to apply to landline and wireless (including satellite) voice communications services. No view is expressed regarding whether Voice Over IP (“VOIP”) is a taxable communications service or a nontaxable information service.

Option 2 incorporates the changes to the tax under Option 1. In addition, under Option 2, a voice communications service is taxable regardless of its technical form. For example, the tax applies to voice communications services using landlines, analog and digital wireless, satellite and VOIP, or any combination.

Option 3 incorporates the changes to the tax under Options 1 and 2. In addition, under Option 3, the communications excise tax base is expanded to include all data communications services to end-users. The taxable base includes local and long distance voice services, VOIP, analog and digital cellular and satellite telephone services, cable and satellite television services (to the extent the charge is for communications), broadband and dial-up Internet access services, paging services, and other data communications services.

B. Equalize Alcohol Excise Taxes (secs. 5001, 5041, and 5051)

On a per ounce basis, distilled spirits are taxed at roughly 21 cents per ounce of alcohol, still wines at 8 cents per ounce of alcohol (assuming an average alcohol content of 12 percent), and beer at 10 cents per ounce of alcohol (assuming alcohol content of 4.5 percent). The differential rates for alcohol products influence production decisions, as producers try to take advantage of the lower wine and beer rates. This in turn has led to compliance problems involving the section 5010 credit (a credit that reduces the tax on distilled spirits for the wine content and flavors content of a distilled spirit), and controversy over the proper tax classification of certain beverages.

The proposal imposes a uniform tax based on the alcohol content contained in the product. The rate of tax is based on proof gallon. Because the rate of tax would not depend on the source of the alcohol, the section 5010 credit is eliminated. The proposal taxes all alcohol at \$8.40 per proof gallon.

C. Subject International Flights with Wholly Domestic Segments to the Segments Tax (secs. 4261 and 4262)

Most domestic air passenger transportation is subject to a two-part excise tax. First, a tax at the rate of 7.5 percent is imposed on the amount paid for taxable transportation. Second, a flight segment tax of \$3.20 is imposed on each domestic segment of taxable transportation. Generally, a domestic segment consists of one takeoff and one landing within the United States.²⁰

Although international flights may include flight segments that consist of takeoffs and landings within the United States (utilizing the same airport flight control resources as a purely domestic flight) such segments are exempt from the domestic segment tax. The proposal imposes the domestic segment tax on these flight segments.

D. Modify the Federal Excise Tax on Sport Fishing Equipment (secs. 4161 and 4162)

In general, a 10-percent excise tax is imposed on the sale by the manufacturer, producer, or importer of specified sport fishing equipment (a few items are taxed at three percent). In addition to fishing rods, poles, and reels, many other items of fishing equipment are taxed. The large number of items subject to the tax creates complexity and administrative burdens for both taxpayers and the IRS. In addition, many of the items subject to the tax have close nontaxable substitutes, leading to highly factual determinations as to whether a particular item is or is not subject to the tax and to disputes between taxpayers and the IRS. This also causes taxpayers to shift from taxable items to nontaxable items, eroding the tax base.

Under the proposal, the excise tax base on sport fishing equipment is narrowed to fishing rods, poles, and reels. This should minimize the complexity, administrative burdens, and base erosion. To maintain the current level of revenue generated by the tax, the rate of tax imposed on taxable articles is adjusted to 21 percent.

²⁰ Domestic segments also include portions of Canada or Mexico that are not more than 225 miles from the nearest point in the continental United States.

XI. ESTATE AND GIFT TAXATION

A. Limit Perpetual Dynasty Trusts (secs. 2631 and 2632)

In general, present law imposes a tax on transfers once each generation. These taxes are in the form of a gift tax for lifetime transfers, an estate tax for transfers at death, and a generation skipping transfer tax for transfers to persons more than one generation younger than the transferor. Present law provides for a lifetime per transferor exemption from the generation skipping transfer tax. The amount of the generation skipping transfer tax exemption is \$1.5 million for generation skipping transfers made in 2005, \$2 million for generation skipping transfers made in 2006, 2007, or 2008, and \$3.5 million for generation skipping transfers made in 2009. Many States have rules that limit the length of time that assets can be held in trust for the benefit of beneficiaries who were not alive at the time of the creation of the trust. These rules are generally referred to as the rule against perpetuities. A number of States have chosen to repeal the rule against perpetuities. It is possible to create trusts in these States, allocate the generation-skipping trust exemption to that trust, and let that trust grow to unlimited amounts over an unlimited number of generations without transfer tax.

The proposal would not permit allocation of the generation skipping tax exemption to a “perpetual dynasty trust,” except to the extent that the trust provides for distributions to beneficiaries in the same generation as the transferor’s children or grandchildren. Under the proposal, the generation-skipping tax exemption effectively would be limited to an exemption of a skip of one-generation.

B. Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes (secs. 2031, 2512, and 2624)

A common estate and gift tax planning technique is to create ownership structures that take advantage of discounts in the tax valuation of property. Under present law, these valuation discounts can significantly reduce the estate and gift tax values of transferred property. Minority and marketability discounts in particular often create substantial reductions in value. Minority discounts are based on the notion that a minority ownership interest in a business may be worth less than a proportionate share of the value of the assets of the business. Marketability discounts are based on the idea that property for which there is no ready market may be less attractive than property in which public trading exists. In some cases the reductions in value for estate and gift tax purposes resulting from minority, marketability, and other discounts do not accurately reflect value. For example, a taxpayer may make gifts to a child of minority interests in property and claim lack-of-control (minority) discounts under the gift tax even though the taxpayer or the taxpayer’s child controls the property being transferred. A taxpayer also may contribute marketable property such as publicly-traded stock to a partnership (such as a family limited partnership) or other entity that he or she controls and, when interests in that entity are transferred through the estate, claim marketability discounts even though the heirs may be able to liquidate the entity and recover the full value by accessing the underlying assets directly.

The proposal restricts a taxpayer’s ability to claim minority and marketability discounts in certain situations in which those discounts do not accurately reflect the value of the property

interests transferred. It achieves this restriction by prescribing rules governing how property is valued for estate and gift tax purposes. One rule determines whether a minority discount is permitted by generally taking into account a transferor's entire ownership interest in property immediately before the transfer of an interest during life or at death. Another rule provides that if marketable assets such as publicly-traded stock account for at least one-third of the value of an entity, the value of an interest in that entity is determined in part by looking through the ownership interest to the marketable assets themselves. Where this rule applies, it has the effect of denying a marketability discount to the extent the entity holds marketable assets.

C. Curtail the Use of Lapsing Trust Powers to Inflate the Gift Tax Annual Exclusion Amount (sec. 2503)

Under present law, gift tax is imposed on transfers of property by gift, subject to several exceptions. One major exception is the gift tax annual exclusion. Under this exclusion, a donor can transfer up to \$11,000 of property to each of an unlimited number of donees without incurring gift tax on such transfers. In order to qualify for the exclusion, the property interests transferred must be present interests, as opposed to future interests (such as remainders). Gifts in trust are treated as made to the trust beneficiaries for purposes of applying the annual exclusion. Accordingly, if the trust beneficiaries have no right to present enjoyment of the transferred property, the annual exclusion will not apply, as no present interest will have been transferred. However, the courts and the IRS have long agreed that a temporary right of withdrawal of trust property on the part of a beneficiary may serve to create a present interest, thus qualifying such a gift for the annual exclusion. This result obtains even if the right of withdrawal is of short duration, and even if all parties involved expect that the right will not be exercised, and thus the beneficiary will not actually "enjoy" the transferred property on a current basis as a practical matter. These powers, and these arrangements in general, are referred to as "Crummey powers," and "Crummey trusts" (so named after a court case upholding one such arrangement). In recent years, taxpayers have used Crummey powers to achieve benefits extending beyond the conversion of future interests into present interests. Specifically, taxpayers have taken the position that the holder of the Crummey power need not even be a vested beneficiary of the trust, which creates the possibility of using multiple annual exclusions (one for each Crummey power holder) for what ultimately will be a gift to a single donee, as a practical matter. The Tax Court has sustained this position.

The proposal sets forth three options that the Congress may wish to consider for improving the tax treatment of Crummey powers. The first option is designed simply to prevent taxpayers from claiming multiple annual exclusions in connection with gifts that are intended and arranged to accrue to a single person. The other two options effectively eliminate Crummey powers altogether.

D. Provide Reporting for a Consistent Basis Between the Estate Tax Valuation and the Basis in the Hands of the Heir (sec. 1014)

The value of an asset for purposes of the estate tax generally is the fair market value at the time of death. The basis of property acquired from a decedent also is generally the fair market value of the property at the time of the decedent's death. Under regulations, the fair market value of the property at the date of the decedent's death is deemed to be its value as

appraised for estate tax purposes. However, the value of property as reported on the decedent's estate tax return provides only a rebuttable presumption of the property's basis in the hands of the heir. Unless the heir is estopped by his or her previous actions or statements with regard to the estate tax valuation, the heir may, by clear and convincing evidence, rebut the use of the estate's valuation as his or her basis. Consequently, the government is potentially whipsawed by inconsistent valuations by an executor of an estate and by an heir: An executor has the incentive to offer conservative estimates of the value of assets in an estate, while for the purpose of determining gain or loss on an inherited asset, generally the heir would prefer a higher basis.

Providing an heir with fair market value information gives the heir records to improve reporting of income upon future realization of gain. Providing the IRS with the same information would better enable the IRS to challenge inappropriate attempts to underreport gain upon a subsequent realization of that gain. The proposal therefore requires that for any property acquired as a bequest from an estate which has a Federal estate tax liability, the executor is required to provide the heir and the IRS with a statement of the value of the asset reported for estate tax purposes. The value so reported is binding on the heir as his or her basis for the purpose of computing future gain or loss. The proposal does not apply to items of income in respect of a decedent or property that the executor of the decedent's estate sells.

E. Modify Transfer Tax Provisions Applicable to Section 529 Qualified Tuition Accounts (sec. 529)

Section 529 qualified tuition programs allow taxpayers to save for future education expenses on a tax-favored basis. Contributions to section 529 accounts are not deductible for Federal tax purposes, but earnings accumulate on a tax-free basis and distributions that are used for qualified education expenses are not taxable. Special gift and estate tax rules apply to qualified tuition programs. In some situations the gift and transfer tax treatment of a section 529 account is unclear. In addition, present law creates opportunities for inappropriate use of section 529 programs. For example, taxpayers may seek to avoid the applicable gift and estate tax rules through the use of multiple accounts and changing beneficiaries.

The proposal clarifies the application of the transfer tax rules to section 529 accounts and modifies the rules applicable to such accounts so as to reduce the likelihood of inappropriate use. In general, under the proposal, a contribution to a qualified tuition account is not treated as a completed gift, and is includible in the estate of the contributor or the account owner, unless the terms governing the account satisfy certain requirements.