

**DESCRIPTION OF THE
FINANCIAL FREEDOM ACT OF 1999**

Scheduled for Markup

by the

HOUSE COMMITTEE ON WAYS AND MEANS

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Prepared by the Staff

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JOINT COMMITTEE ON TAXATION



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INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the provisions in the Financial Freedom Act of 1999, which is scheduled for markup in the House Committee on Ways and Means beginning on July 12, 1999.

This document contains descriptions of the following provisions in the Chairman's Mark: (1) broad-based tax relief provisions, including marriage penalty tax relief and individual alternative minimum tax relief provisions, (2) savings and investment tax relief provisions, (3) business investment and job creation provisions, (4) education tax relief provisions, (5) health care tax relief provisions, (6) death tax relief provisions, (7) provisions relating to distressed communities and industries, (8) small business tax relief provisions, (9) international tax relief provisions, (10) tax-exempt organization provisions, (11) real estate tax relief provisions, (12) pension reform provisions, (13) miscellaneous provisions, (14) extension of expired and expiring provisions, (15) revenue offset provisions, and (16) tax technical correction provisions.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of The Financial Freedom Act of 1999*, (JCX-42-99), July 12, 1999.

I. BROAD-BASED TAX RELIEF

A. Reduction in Individual Income Tax Rates

Present Law

Income tax rate structure

To determine regular income tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. The income bracket amounts are indexed for inflation. Separate rate schedules apply based on an individual's filing status. In order to limit multiple uses of a graduated rate schedule within a family, the net unearned income of a child under age 14 is taxed as if it were the parent's income. For 1999, the individual regular income tax rate schedules are shown below.

Table 1.—Federal Individual Income Tax Rates for 1999

If taxable income is:	Then income tax equals:
	<i>Single individuals</i>
\$0-25,750	15 percent of taxable income
\$25,750-\$62,450	\$3,862.50, plus 28% of the amount over \$25,750
\$62,450-\$130,250	\$14,138.50 plus 31% of the amount over \$62,450
\$130,250-\$283,150	\$35,156.50 plus 36% of the amount over \$130,250
Over \$283,150	\$90,200.50 plus 39.6% of the amount over \$283,150
	<i>Heads of households</i>
\$0-\$34,550	15 percent of taxable income
\$34,550-\$89,150	\$5,182.50 plus 28% of the amount over \$34,550
\$89,150-\$144,400	\$20,470.50 plus 31% of the amount over \$89,150
\$144,400-\$283,150	\$37,598 plus 36% of the amount over \$144,400
Over \$283,150	\$87,548 plus 39.6% of the amount over \$283,150
	<i>Married individuals filing joint returns</i>
\$0-\$43,050	15 percent of taxable income
\$43,050-\$104,050	\$6,457.50 plus 28% of the amount over \$43,050
\$104,050-\$158,550	\$23,537.50 plus 31% of the amount over \$104,050
\$158,550-\$283,150	\$40,432.50 plus 36% of the amount over \$158,550
Over \$283,150	\$85,288.50 plus 39.6% of the amount over \$283,150

Individual alternative minimum tax (“AMT”) rate structure

Present law imposes the individual AMT on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. The AMT is imposed upon individuals at rates of (1) 26 percent on the first \$175,000 of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent on the amount in excess of \$175,000. AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. The exemption amounts are \$45,000 in the case of married individuals filing a joint return and surviving spouses; \$33,750 in the case of other unmarried individuals; and \$22,500 in the case of married individuals filing a separate return. These exemption amounts are phased-out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds a threshold amount. The threshold amounts are \$150,000 in the case of married individuals filing a joint return and surviving spouses; \$112,500 in the case of other unmarried individuals; and \$75,000 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts, the threshold phase-out amounts, and the \$175,000 break-point amount are not indexed for inflation. The lower capital gains rates applicable to the regular tax also apply for purposes of the AMT.

Description of Proposal

In general

The proposal would reduce the regular income tax rates by 10 percent over a ten-year period (2000-2009). Specifically, each rate would be reduced by 2.5 percent for taxable years beginning in 2001-2004, 5 percent in 2005-2007, 7.5 percent in 2008, and 10 percent in 2009 and thereafter. The tax rates would be rounded up annually to the nearest one-tenth of a percent. The following table shows the regular tax rate structure under the proposal.

Individual Regular Tax Rates

1999-2000	2001-2004	2005-2007	2008	2009 & THEREAFTER
15%	14.7%	14.3%	13.9%	13.5%
28%	27.3%	26.6%	25.9%	25.2%
31%	30.3%	29.5%	28.7%	27.9%
36%	35.1%	34.2%	33.3%	32.4%
39.6%	38.7%	37.7%	36.7%	35.7%

This rate reduction would not apply to the capital gains tax rates. However, a separate proposal (described in Part II.B., below) would reduce individual capital gains rates.

Individual AMT

The proposal would also reduce the individual AMT tax rates by a total of 2.5 percent for taxable years beginning in 2001-2004, 5 percent in 2005-2007, 7.5 percent in 2008, and 10 percent in 2009 and thereafter. The rates would be rounded up annually to the nearest one-tenth of a percent, like the regular income tax rates. The following table shows the AMT rate structure under the proposal. See, however, the proposal in Part C., below, to repeal the individual AMT. The rate reductions described above become obsolete when the repeal of the individual AMT is fully phased in.

Individual AMT Rates

1999-2000	2001-2004	2005-2007	2008	2009 & THEREAFTER
26%	25.4%	24.7%	24.1%	23.4%
28%	27.3%	26.6%	25.9%	25.2%

Effective Date

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

B. Marriage Penalty Tax Relief

1. Standard deduction tax relief

Present Law

Marriage penalty

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

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

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

Under present law, the size of the standard deduction and the tax bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and tax bracket breakpoints for single filers are roughly 60 percent of those for joint filers.² With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable), which is subtracted (along with the deduction for personal exemptions) from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is indexed for inflation. For 1999, the size of the basic standard deduction is projected to be as follows:

² This is not true for the 39.6-percent rate. The beginning point of this rate bracket is the same for all taxpayers regardless of filing status.

<u>Filing status</u>	<u>Basic standard deduction</u> ³
Married, joint return.....	\$7,200
Head of household return.....	\$6,250
Single return.....	\$4,300
Married, separate return.....	\$3,600

For 1999, the basic standard deduction for joint returns is projected to be 1.674 times the basic standard deduction for single returns.

Description of Proposal

The proposal would increase the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual in each taxable year. This increase would be phased-in over three years beginning in 2001 by increasing the standard deduction for a married couple filing a joint return to 1.778 times the standard deduction for an unmarried individual in 2001 and to 1.889 times such amount in 2002. Therefore, the proposal would be fully effective, (i.e., the basic standard deduction for a married couple would be twice the basic standard deduction for an unmarried individual) for taxable years beginning after December 31, 2002. Also, the basic standard deduction for a married taxpayer filing separately would be increased so that it would continue to equal one-half of the basic standard deduction for a married couple filing jointly. The basic standard deduction for a head of household would be unchanged.

Effective Date

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

2. Adjust student loan interest deduction income limits

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit (sec. 221). The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include nonmandatory payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the

³ Joint Committee on Taxation staff projections.

qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for certain costs of attendance (including room and board) of a student (who may be the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred) who is enrolled in a degree program on at least a half-time basis at (1) an accredited post-secondary educational institution defined by reference to section 481 of the Higher Education Act of 1965, or (2) an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The maximum allowable deduction per taxpayer return is \$1,500 in 1999, \$2,000 in 2000, and \$2,500 in 2001 and thereafter.⁴ The deduction is phased out ratably for individual taxpayers with modified adjusted gross income of \$40,000-\$55,000 and \$60,000-\$75,000 for joint returns. The income ranges will be indexed for inflation after 2002.

Description of Proposal

The proposal would increase the beginning point of the income phaseout for the student loan interest deduction for taxpayers filing joint returns to twice the beginning point of the income phaseouts applicable to single taxpayers and would double the phaseout range for joint filers. Thus, beginning in 2001, the deduction would be phased out ratably for taxpayers filing joint returns with modified adjusted gross income of \$80,000 to \$110,000.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

3. Increase income limit for Roth IRA conversions

Present Law

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that an individual may make to a Roth IRA is the lesser of \$2,000 or the individual's compensation for the year. This contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. With respect to married individuals, a contribution of up to \$2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual Roth IRA contribution is phased out for single individuals with AGI between \$95,000 and \$110,000, and for married individuals filing joint

⁴ The maximum allowable deduction for 1998 was \$1,000.

returns with AGI between \$150,000 and \$160,000.

A taxpayer with AGI of \$100,000 or less generally may convert a deductible or nondeductible IRA into a Roth IRA, unless the taxpayer is a married individual filing a separate return. The value of the IRA that is converted is includible in income as if the taxpayer made a withdrawal, except that the 10-percent early withdrawal tax does not apply.

Description of Proposal

The proposal would increase for married individuals filing joint returns the present-law \$100,000 AGI limitation on conversion of a deductible or nondeductible IRA into a Roth IRA. The increased AGI limitation would match the upper end of the Roth IRA contribution phase-out range for married individuals filing joint returns. Therefore, married individuals filing joint returns with AGI not exceeding \$160,000 would be permitted to convert a deductible or nondeductible IRA into a Roth IRA.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

C. Repeal Individual Alternative Minimum Tax

Present Law

In general

Present law imposes a minimum tax (“AMT”) on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. The AMT is imposed on individuals at rates of (1) 26 percent on the first \$175,000 of alternative minimum taxable income (“AMTI”) in excess of a phased-out exemption amount and (2) 28 percent on the remaining AMTI. The exemption amounts are \$45,000 in the case of married individuals filing a joint return and surviving spouses; \$33,750 in the case of other unmarried individuals; and \$22,500 in the case of married individuals filing a separate return. These exemption amounts are phased-out by an amount equal to 25 percent of the amount that the individual's AMTI exceeds a threshold amount. These threshold amounts are \$150,000 in the case of married individuals filing a joint return and surviving spouses; \$112,500 in the case of other unmarried individuals; and \$75,000 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts, the threshold phase-out amounts, and the \$175,000 break-point amount are not indexed for inflation. The lower capital gains rates applicable to the regular tax apply for purposes of the AMT.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

Preference items in computing AMTI

The minimum tax preference items are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.

(3) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(4) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

(5) Forty-two percent of the amount excluded from income under section 1202 (relating to

gains on the sale of certain small business stock).

In addition, losses from any tax shelter, farm, or passive activities are denied.⁵

Adjustments in computing AMTI

The adjustments that individuals must make in computing AMTI are:

(1) Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence.

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

(4) The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

(5) Miscellaneous itemized deductions are not allowed.

(6) Itemized deductions for State, local, and foreign real property taxes, State and local personal property taxes, and State, local, and foreign income, war profits, and excess profits taxes are not allowed.

(7) Medical expenses are allowed only to the extent they exceed 10 percent of the taxpayer's adjusted gross income (AGI).

(8) Standard deductions and personal exemptions are not allowed.

(9) The amount allowable as a deduction for circulation expenditures must be capitalized

⁵ Given the passage of section 469 by the Tax Reform Act of 1986 (relating to the deductibility of losses from passive activities), these provisions are largely "deadwood."

and amortized over a 3-year period.

(10) The amount allowable as a deduction for research and experimental expenditures must be capitalized and amortized over a 10-year period.⁶

(11) The regular tax rules relating to incentive stock options do not apply.

Other rules

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's AMT liability by more than 90 percent of the amount determined without these items.

The various nonrefundable credits allowed under the regular tax generally are allowed only to the extent that the individual's regular tax exceeds the tentative minimum tax. The earned income credit and the child credit of those taxpayers with three or more qualified children are refundable credits and may offset the taxpayer's tentative minimum tax. However, a taxpayer must reduce these refundable credits by the taxpayer's AMT.⁷

If an individual is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax in such subsequent year. For individuals, the AMT credit is allowed only to the extent the taxpayer's AMT liability is a result of adjustments that are timing in nature. Most individual AMT adjustments relate to itemized deductions and personal exemptions and are not timing in nature.

Description of Proposal

The proposal would allow an individual to offset the entire regular tax liability (without regard to the minimum tax) by the personal nonrefundable credits. The proposal also would repeal the provision reducing the refundable child credit by the AMT.

The proposal would phase-out the individual AMT. For taxable years beginning in 2003, only 80 percent of the full AMT liability would be imposed. That percentage would be reduced to 70 percent in 2004, 60 percent in 2005, 50 percent in 2006 and 2007, and the tax would be fully repealed for taxable years beginning after 2007.

An individual would be allowed to use the AMT credit to offset 90 percent of its regular tax

⁶ No adjustment is required if the taxpayer materially participates in the activity that relates to the research and experimental expenditures.

⁷ For 1998 only, the nonrefundable personal credits were not limited by the tentative minimum tax, and the refundable child credit was not reduced by the minimum tax.

liability (determined after the application of the other nonrefundable credits).

The repeal of the individual AMT would eliminate the present-law marriage penalty in the individual AMT.

Effective Dates

The provisions relating to the personal credits would be effective for taxable years beginning after December 31, 1998. The phase-out of the AMT would be effective for taxable years beginning after December 31, 2002 . The repeal of the AMT and the provision relating to the use of AMT credits would apply to taxable years beginning after December 31, 2007.

II. SAVINGS AND INVESTMENT TAX RELIEF PROVISIONS

A. Partial Exclusion for Interest and Dividends

Present Law

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

Description of Proposal

The proposal would provide individual taxpayers an exclusion from income of interest and dividends (other than capital gain dividends from RICs and REITs, dividends from farmers’ cooperative associations, and dividends received from an employee stock ownership plan) received in a taxable year.⁸ The maximum exclusion from income would be \$100 of combined interest and dividends (\$200 for married couples filing a joint return) for taxable years beginning after December 31, 2000. The maximum exclusion would be \$200 of combined interest and dividends (\$400 for married couples filing a joint return) for taxable years beginning after December 31, 2002. The amount of the combined interest and dividends excluded under this proposal would be in addition to any interest or dividend which is exempt from tax under any other provision of the law (e.g., interest on certain State and local bonds which is exempt from tax under section 103 of the Code).

In determining eligibility for the earned income credit (“EIC”), any interest or dividends excluded from gross income under this proposal would continue to be included in modified adjusted gross income for purposes of phase-out rules of the EIC and disqualified income for purposes of the EIC disqualified income test. Similarly, any interest or dividends excluded from gross income under this proposal would continue to be included in modified adjusted gross income for purposes of the taxation of certain Social Security benefits.

The fact that dividends may be excluded from income pursuant to this proposal would not affect the computation of the foreign tax credit.

The exclusion under this proposal would be in addition to, and would be applied after, the exclusion for educational savings bond interest (sec. 135). In applying those provisions of the Code (such as secs. 86, 219, 221, and 469) that determine modified adjusted gross income without regard to section 135, it is intended that the exclusion under this proposal be computed without regard to the exclusion under section 135.

⁸ From 1954 until 1986, the Code (sec. 116) contained an exclusion from income (in varying amounts) for dividends. For 1981 only, that provision was also extended to interest; this proposal is generally parallel to that provision. The exclusion for dividends was repealed by the Tax Reform Act of 1986.

In addition, the proposal would also encourage the IRS to simplify the process of completing tax forms to the greatest extent practicable, including, for example, considering raising the administratively-established dollar thresholds for completing Schedule B or for being able to use the Form 1040EZ.

Effective Date

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

B. Reduce Individual Capital Gains Rates

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, any gain generally is included in income, and the net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

The maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. In addition, any adjusted net capital gain which otherwise would be taxed at the lowest individual rate (currently, 15 percent) is taxed at a 10-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

The "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain which the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) ("collectibles gain and loss"), an amount of gain equal to the amount of gain excluded from gross income under section 1202, relating to certain small business stock ("section 1202 gain"),⁹ the net short-term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the

⁹ This results in a maximum effective regular tax rate on qualified gain from small business stock of 14 percent. The maximum rate under the alternative minimum tax is 19.88 percent.

extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, rather than only to a portion of the depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies shall not exceed the net section 1231 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent.

For taxable years beginning after December 31, 2000, any gain from the sale or exchange of property held more than five years which would otherwise be taxed at the 10-percent rate will instead be taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which begins after December 31, 2000, which would otherwise be taxed at a 20-percent rate will be taxed at an 18-percent rate. A taxpayer holding a capital asset or property used in the trade or business on January 1, 2001, may elect to treat the asset as having been sold in a taxable transaction on that date for an amount equal to its fair market value, and having been reacquired for an amount equal to such value.

Description of Proposal

The proposal would reduce the 10- and 20-percent rates on the adjusted net capital gain to 7.5 and 15 percent, respectively. The 25-percent rate on unrecaptured section 1250 gain would be reduced to 20 percent. These lower rates would apply to both the regular tax and the alternative minimum tax.¹⁰

The proposal would repeal the 8- and 18-percent rates on certain gain from property held more than 5 years.

Effective Date

The proposal would apply to taxable years ending on or after July 1, 1999.

For taxable years which include July 1, 1999, the lower rates would apply to amounts properly taken into account for the portion of the year on or after that date. This generally has the effect of applying the lower rates to capital assets sold or exchanged (and installment payments received) on or after July 1, 1999. In the case of gain taken into account by a pass-through entity, the date taken into account by the entity is the appropriate date for applying this rule.

¹⁰ The proposal would not change the regular tax rate for gain from collectibles and small business stock. The proposal would reduce the maximum effective AMT rate on small business stock to 14.84 percent.

C. Apply Capital Gain Rates to Capital Gains Earned by Designated Settlement Funds

Present Law

Under present law, designated settlement funds are taxed at the highest rate of tax imposed on individuals, currently 39.6 percent, on their entire taxable income (sec. 468B).

Description of Proposal

Under the proposal, the net capital gain of a designated settlement fund would be taxed in the same manner as in the case of an individual, i.e., the lower rates applicable to net capital gain set forth in section 1(h) would apply.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1999.

**D. Exclusion of Gain on the Sale of a Principal Residence by a
Member of the Uniformed Service or the Foreign Service of the United States
or Certain Other Individuals Relocated Outside of the United States**

Present Law

Under present law, an individual taxpayer may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is able to exclude an amount equal to the fraction of the \$250,000 (\$500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met. There are no special rules relating to: (1) members of the uniformed services or the Foreign Service of the United States or (2) individuals relocated outside of the United States.

Description of Proposal

Under the proposal, the five-year test period for ownership and use would be suspended during certain absences due to service in the uniformed services or the Foreign Service of the United States. The uniformed services would include: (1) the armed forces (the Army, Navy, Air Force, Marine Corp, and Coast Guard); (2) the commissioned corps of the National Oceanic and Atmospheric Administration; and (3) the commissioned corps of the Public Health Service. Specifically, the five-year period ending on the date of the sale or exchange of a principal residence would not include any periods during which the taxpayer or the taxpayer's spouse was on qualified official extended duty as a member of the uniformed services or the Foreign Service of the United States. Qualified official extended duty would be any period of extended duty by a member of the uniformed services or the Foreign Service of the United States while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in Government furnished quarters. Extended duty would be defined as any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

The proposal would also suspend for up to five years, the five-year test period for an individual relocated for a period of more than 90 days outside of the United States by the individual's (or spouse's) employer. This proposal would not apply to self-employed individuals.

Effective Date

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

E. Treatment of Loss on Stock of Subsidiary

Present Law

Under present law, the loss on stock of a subsidiary corporation that becomes worthless is treated as an ordinary loss (rather than a capital loss), unless 10 percent or more of its gross receipts for all taxable years has been, with minor exceptions, from royalties, rents, dividends, interest, annuities, and gains from the sales or exchanges of stocks and securities (sec. 165(g)(3)).

Description of Proposal

Under the proposal, income from the conduct of an active trade or business of an insurance company or financial institution would not be included as gross receipts from the types of passive income listed above. Thus, a loss recognized with respect to the worthless stock of a subsidiary corporation which is an insurance company or financial institution could be treated as an ordinary loss, rather than as a capital loss.

Effective Date

The proposal would apply to stock becoming worthless in taxable years beginning after December 31, 1999.

F. Clarify the Tax Treatment of Income and Losses on Derivatives

Present Law

Capital gain treatment applies to gain on the sale or exchange of a capital asset. Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, or (4) certain copyrights (or similar property) and U.S. government publications. Gain or loss on such assets generally is treated as ordinary, rather than capital, gain or loss. Certain other Code sections also treat gains or losses as ordinary. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to “mark-to-market” accounting are treated as ordinary (sec. 475).

Under case law in a number of Federal courts prior to 1988, business hedges generally were treated as giving rise to ordinary, rather than capital, gain or loss. In 1988, the U.S. Supreme Court rejected this interpretation in Arkansas Best v. Commissioner, 485 U.S. 212 (1988), which, relying on the statutory definition of a capital asset described above, held that a loss realized on a sale of stock was capital even though the stock was purchased for a business, rather than an investment, purpose.

In 1993, the Department of the Treasury issued temporary regulations, which were finalized in 1994, that require ordinary character treatment for most business hedges and provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The regulations apply to hedges that meet a standard of “risk reduction” with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer and that meet certain identification and other requirements (Treas. reg. sec. 1.1221-2).

Description of Proposal

The proposal would add three categories to the list of assets gain or loss on which is treated as ordinary (sec. 1221). The new categories would be: (1) commodities derivative financial instruments entered into by derivative dealers; (2) hedging transactions; and (3) supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer’s trade or business.

In defining a hedging transaction, the proposal generally would codify the approach taken by the Treasury regulations, but would modify the rules. The “risk reduction” standard of the regulations would be broadened to one of “risk management” with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred). As under the Treasury regulations, the transaction would have to be identified as a hedge of specified property. Authority would be provided for regulations that would address improperly identified or non-identified hedging transactions. The Treasury Secretary would be given authority to apply these rules to related parties.

Effective Date

The proposal would be effective for any instrument held, acquired or entered into, any transaction entered into, and supplies held or acquired on or after the date of enactment.

III. BUSINESS INVESTMENT AND JOB CREATION

A. Alternative Tax for Corporate Capital Gains

Present Law

Under present law, the net capital gain of a corporation is taxed at the same rates as ordinary income, and subject to tax at graduated rates up to 35 percent.

Description of Proposal

Under the proposal, an alternative tax would apply to the net capital gain of a corporation if that tax is lower than the corporation's regular tax. For taxable years beginning in 2000, the rate of the alternative tax would be 34 percent. The alternative tax rate would be reduced thereafter by one percentage point a year (e.g., 33 percent in 2001), until a 25-percent rate is reached. The 25-percent rate would apply to taxable years beginning after 2008.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1999.

B. Repeal Corporate Alternative Minimum Tax

Present Law

In general

Present law imposes a minimum tax on a corporation to the extent the corporation's minimum tax liability exceeds its regular tax liability. This alternative minimum tax ("AMT") is imposed on corporations at the rate of 20 percent on the alternative minimum taxable income ("AMTI") in excess of a \$40,000 phased-out exemption amount. The exemption amount is phased-out by an amount equal to 25 percent of the amount that the corporation's AMTI exceeds \$150,000.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

A corporation with average gross receipts of less than \$7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The \$7.5 million threshold is reduced to \$5 million for the corporation's first 3-taxable year period.

Preference items in computing AMTI

The corporate minimum tax preference items are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.

(3) Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.

(4) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

Adjustments in computing AMTI

The adjustments that corporations must make in computing AMTI are:

(1) Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence.

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

(4) The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

(5) The special rules applicable to Merchant Marine construction funds are not applicable.

(6) The special deduction allowable under section 833(b) Blue Cross and Blue Shield organizations is not allowed.

(7) The adjusted current earnings adjustment, described below.

Adjusted current earning (ACE) adjustment

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings (“ACE”) of a corporation exceeds its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction. In determining ACE the following rules apply:

(1) For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.

(2) Any amount that is excluded from gross income under the regular tax but is included for purposes of determining earnings and profits is included in determining ACE.

(3) The inside build-up of a life insurance contract is included in ACE (and the related premiums are deductible).

(4) Intangible drilling costs of integrated oil companies must be capitalized and amortized over a 60-month period.

(5) The regular tax rules of section 173 (allowing circulation expenses to be amortized) and section 248 (allowing organizational expenses to be amortized) do not apply.

(6) Inventory must be calculated using the FIFO, rather than LIFO, method.

(7) The installment sales method generally may not be used.

(8) No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.

(9) Depletion (other than for oil and gas) must be calculated using the cost, rather than the percentage, method.

(10) In certain cases, the assets of a corporation that has undergone an ownership change must be stepped-down to their fair market values.

Other rules

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's AMT liability by more than 90 percent of the amount determined without these items.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT.

If a corporation is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in such subsequent year.

Description of Proposal

For taxable years beginning in 2003, the limitation on the amount of AMT credits allowable to a corporation would be increased by 20 percent of the corporation's tentative minimum tax. This percentage would be raised to 30 and 40 percent, respectively, for 2004 and 2005, and would be raised to 50 percent for 2006 and 2007. The AMT credit could not exceed an amount equal to the sum of the regular tax and minimum tax less the other nonrefundable credits.

For taxable years beginning after 2007, the proposal would repeal the corporate AMT. A corporation then would be allowed to use the AMT credit to offset 90 percent of its regular tax

liability (determined after the application of other nonrefundable credits).

Effective Date

The proposal allowing the AMT credit to offset a portion of the minimum tax would apply to taxable years beginning after December 31, 2002.

The proposal repealing the AMT would apply to taxable years beginning after December 31, 2007.

C. Repeal of Limitation of Foreign Tax Credit under Alternative Minimum Tax

Present Law

Under present law, taxpayers are subject to an alternative minimum tax ("AMT"), which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax liability. The tax is imposed at a flat rate of 20 percent, in the case of corporate taxpayers, on alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount. The maximum rate for noncorporate taxpayers is 28 percent. AMTI is the taxpayer's taxable income increased for certain tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the exclusion or deferral of income resulting from the regular tax treatment of those items.

Taxpayers are permitted to reduce their AMT liability by an AMT foreign tax credit. The AMT foreign tax credit for a taxable year is determined under principles similar to those used in computing the regular tax foreign tax credit, except that (1) the numerator of the AMT foreign tax credit limitation fraction is foreign source AMTI and (2) the denominator of that fraction is total AMTI.¹¹ Taxpayers may elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source *regular* taxable income to total AMTI (sec. 59(a)(4)).

The AMT foreign tax credit for any taxable year generally may not offset a taxpayer's entire pre-credit AMT. Rather, the AMT foreign tax credit is limited to 90 percent of AMT computed without an AMT net operating loss deduction, an AMT energy preference deduction, or an AMT foreign tax credit. For example, assume that a corporation has \$10 million of AMTI, has no AMT net operating loss or energy preference deductions, and is subject to the AMT. In the absence of the AMT foreign tax credit, the corporation's tax liability would be \$2 million. Accordingly, the AMT foreign tax credit cannot be applied to reduce the taxpayer's tax liability below \$200,000. Any unused AMT foreign tax credit may be carried back 2 years and carried forward 5 years for use against AMT in those years under the principles of the foreign tax credit carryback and carryforward rules set forth in section 904(c).

Description of Proposal

The proposal would repeal the 90-percent limitation on the utilization of the AMT foreign tax credit.

Effective Date

¹¹ Similar to the regular tax foreign tax credit, the AMT foreign tax credit is subject to the separate limitation categories set forth in section 904(d). Under the AMT foreign tax credit, however, the determination of whether any income is high taxed for purposes of the high-tax-kick-out rules (sec. 904(d)(2)) is made on the basis of the applicable AMT rate rather than the highest applicable rate of regular tax.

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

IV. EDUCATION TAX RELIEF PROVISIONS

A. Expand Education Individual Retirement Accounts

Present Law

In general

Section 530 provides tax-exempt status to education individual retirement accounts (“education IRAs”), meaning certain trusts (or custodial accounts) which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a named beneficiary.¹² Contributions to education IRAs may be made only in cash. Annual contributions to education IRAs may not exceed \$500 per designated beneficiary (except in cases involving certain tax-free rollovers, as described below), and may not be made after the designated beneficiary reaches age 18.¹³ Moreover, an excise tax is imposed if a contribution is made by any person to an education IRA established on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program (defined under sec. 529) on behalf of the same beneficiary.

Phase-out of contribution limit

The \$500 annual contribution limit for education IRAs is phased out ratably for contributors with modified adjusted gross income (“AGI”) between \$95,000 and \$110,000 (between \$150,000 and \$160,000 for joint returns). Individuals with modified AGI above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any individual.

Treatment of distributions

Amounts distributed from an education IRA are excludable from gross income to the extent that the amounts distributed do not exceed qualified higher education expenses of the designated beneficiary incurred during the year the distribution is made (provided that a HOPE credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). Distributions from an education IRA are generally deemed to consist of distributions of principal (which, under all circumstances, are excludable from gross income) and earnings (which may be excludable from gross income) by applying the ratio that the aggregate amount of contributions to the account for the beneficiary bears to the total balance of the account. If the qualified higher education expenses of the student for the year are at least equal to the total amount of the distribution (i.e., principal and earnings combined) from an education IRA, then the earnings in

¹² Education IRAs generally are not subject to Federal income tax, but are subject to the unrelated business income tax (“UBIT”) imposed by section 511.

¹³ An excise tax may be imposed under present law to the extent that excess contributions above the \$500 annual limit are made to an education IRA.

their entirety are excludable from gross income. If, on the other hand, the qualified higher education expenses of the student for the year are less than the total amount of the distribution (i.e., principal and earnings combined) from an education IRA, then the qualified higher education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings are excludable (i.e., a portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the distributee's gross income.

To the extent that a distribution exceeds qualified higher education expenses of the designated beneficiary, an additional 10-percent tax is imposed on the earnings portion of such excess distribution, unless such distribution is made on account of the death or disability of, or scholarship received by, the designated beneficiary. The additional 10-percent tax also does not apply to the distribution of any contribution to an education IRA made during the taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

Present law allows tax-free transfers or rollovers of account balances from one education IRA benefitting one beneficiary to another education IRA benefitting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary. For this purpose, a "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws--and any spouse of such persons or of the original beneficiary.

Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the named beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).

Qualified higher education expenses

The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Moreover, the term "qualified higher education expenses" includes certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program, as defined in section 529, for the benefit of the beneficiary of the education IRA.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance for

the benefit of the beneficiary that is excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127.¹⁴

Present law also provides that, if any qualified higher education expenses are taken into account in determining the amount of the exclusion for a distribution from an education IRA, then no deduction (e.g., for trade or business expenses deductible under sec. 162), or exclusion (e.g., for expenses paid with interest on education savings bonds excludable under sec. 135), or credit is allowed with respect to such expenses.

Eligible educational institution

Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Description of Proposal

Annual contribution limit

The proposal would increase the annual education IRA contribution limit to \$2,000. Thus, under the proposal, aggregate contributions that could be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary would be limited to \$2,000 for each year in years beginning after 2000.

Qualified expenses

The proposal would expand the definition of qualified education expenses that may be paid with tax-free distributions from an education IRA for distributions made in taxable years beginning after December 31, 2000. Specifically, the definition of qualified education expenses would be expanded to include "qualified elementary and secondary education expenses," meaning (1) tuition, fees, academic tutoring, special needs services, books, supplies, and equipment (including computers and related software and services) incurred in connection with the enrollment or attendance of the designated beneficiary as an elementary or secondary student at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12), and (2) room and board, uniforms, transportation, and supplementary items and services (including

¹⁴ No reduction of qualified higher education expenses is required, however, for a gift, bequest, devise, or inheritance.

extended-day programs) required or provided by such a school in connection with such enrollment or attendance of the designated beneficiary.¹⁵ “Qualified elementary and secondary education expenses” also would include certain homeschooling education expenses if the requirements of any applicable State or local law are met with respect to such homeschooling.

Under the proposal, the definition of “qualified higher education expenses” would be modified to mean: (1) tuition and fees required for the enrollment or attendance of a designated beneficiary at an eligible education institution, and (2) an amount determined by the educational institution for purposes of Federal financial assistance programs as a reasonable allowance for books, supplies, and equipment.¹⁶ The proposal also would provide that “qualified higher education expenses” shall not include expenses for education involving sports, games, or hobbies unless this education is part of the student’s degree program or is taken to acquire or improve job skills of the individual. The proposal would not change the definition of “qualified higher education expenses” with respect to expenses for room and board.

Special needs beneficiaries

The proposal also would provide that, although contributions to an education IRA generally may not be made after the designated beneficiary reaches age 18, contributions may continue to be made to an education IRA in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, under the proposal, in the case of a special needs beneficiary, a deemed distribution of any balance in an education IRA would not occur when the beneficiary reaches age 30.

Contributions by persons other than individuals

The proposal would clarify that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution. As under present law, the eligibility of high-income individuals to make contributions to education IRAs would be phased out ratably for individuals with modified AGI between \$95,000 and \$110,000 (\$150,000 and \$160,000 for joint returns).

¹⁵ Under the proposal, it is intended that contributions made to education IRAs prior to December 31, 2000, (and earnings thereon) could be used for distributions for qualified elementary and secondary education expenses made after January 1, 2001. Thus, it would not be necessary for trustees of education IRAs to keep separate accounts with respect to contributions made prior to January 1, 2001, and earnings thereon.

¹⁶ “Qualified higher education expenses” for purposes of education IRAs are defined by reference to the definition of such expenses for purposes of qualified State tuition programs (sec. 530(b)(2)(A)). Because the proposal would modify the definition of “qualified higher education expenses” for purposes of qualified State tuition programs (sec. 529(e)(3)), the definition of qualified higher education expenses for education IRAs would also be modified.

Contributions permitted until April 15

Under the proposal, individual contributors to education IRAs would be deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (not including extensions), generally April 15.¹⁷ The proposal also would provide that the additional 10-percent tax would not apply to the distribution of any contribution to an education IRA made during the taxable year if such distribution is made on or before the first day of the sixth month of the taxable year (generally June 1) following the taxable year during which the contribution was or was deemed made.¹⁸

Coordination with HOPE and Lifetime Learning credits

For distributions made after December 31, 2000, the proposal would allow a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed.

Coordination with qualified tuition programs

The proposal would repeal the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary (sec. 4973(e)(1)(B)).

Change Name to “Education Savings Accounts”

The proposal would change the name of education IRAs to “Education Savings Accounts.”

Effective Date

The proposals modifying education IRAs generally would be effective for taxable years beginning after December 31, 2000. The proposal to modify the definition of “qualified higher education expenses” would apply to amounts paid for education furnished after December 31,

¹⁷ Under the proposal, it is intended that trustees of education IRAs would require documentation from a contributor (whether an individual, corporation, or other entity) indicating the taxable year to which the contribution should be allocated.

¹⁸ Thus, taxpayers would have approximately one and one-half months after the April 15 deadline for making contributions to an education IRA on account of the preceding year to determine whether an excess contribution was made to an education IRA and distribute (or reallocate to the current taxable year) the excess in order to avoid the additional 10-percent tax.

1999, the same date that this proposal is effective for qualified state tuition plans described in section 529. The proposal to change the name of education IRAs to Education Savings Accounts would be effective on the date of enactment.

B. Allow Tax-free Distributions from State and Private Education Programs

Present Law

Section 529 provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a "savings account plan"). The term "qualified higher education expenses" generally has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution¹⁹, as well as certain room and board expenses for any period during which the student is at least a half-time student.

No amount is included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) are included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.²⁰

A qualified State tuition program is required to provide that purchases or contributions only be made in cash.²¹ Contributors and beneficiaries are not allowed to directly or indirectly direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as

¹⁹ "Eligible educational institutions" are defined the same for purposes of education IRAs (described in II.1., above) and qualified State tuition programs.

²⁰ Distributions from qualified State tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

²¹ Sections 529(c)(2), (c)(4), and (c)(5), and section 530(d)(3) provide special estate and gift tax rules for contributions made to, and distributions made from, qualified State tuition programs and education IRAs.

scholarships. A transfer of credits (or other amounts) from one account benefitting one designated beneficiary to another account benefitting a different beneficiary is considered a distribution (as is a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means persons described in paragraphs (1) through (8) of section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws--and any spouse of such persons or of the original beneficiary. Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses.

To the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the distributee (or another taxpayer claiming the distributee as a dependent) may claim the HOPE credit or Lifetime Learning credit under section 25A with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phaseout for those credits does not apply).

Description of Proposal

Qualified tuition program

The proposal would expand the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law State sponsorship rule). In the case of a qualified tuition program maintained by one or more private educational institutions, persons would be able to purchase tuition credits or certificates on behalf of a designated beneficiary as set forth in section 529(b)(1)(A)(i), but would not be able to make contributions to an account described in section 529(b)(1)(A)(ii) (so-called "savings account plans").

Exclusion from gross income

Under the proposal, an exclusion from gross income would be provided for distributions made in taxable years beginning after December 31, 2000, from qualified State tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income would be extended to distributions from qualified tuition programs established and maintained by an entity other than a State or agency or instrumentality thereof, for distributions made in taxable years after December 31, 2003.

The proposal also would allow a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal

and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

Definition of qualified higher education expenses

Under the proposal, the definition of “qualified higher education expenses” would be modified to mean: (1) tuition and fees required for the enrollment or attendance of a designated beneficiary at an eligible education institution, and (2) an amount determined by the educational institution for purposes of federal financial assistance programs as a reasonable allowance for books, supplies, and equipment. The proposal also would provide that “qualified higher education expenses” shall not include expenses for education involving sports, games, or hobbies unless this education is part of the student’s degree program or is taken to acquire or improve job skills of the individual. The proposal would not change the definition of “qualified higher education expenses” with respect to expenses for room and board.

Rollovers for benefit of same beneficiary

The proposal would clarify that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary will not be considered a distribution for a maximum of one such transfer in each 1-year period.

Member of family

The proposal would provide that, for purposes of tax-free rollovers and changes of designated beneficiaries, a “member of the family” includes first cousins of the original beneficiary.

Effective Date

The proposal permitting the establishment of qualified tuition programs maintained by one or more private educational institutions would be effective for taxable years beginning after December 31, 2000. The exclusion from gross income for certain distributions from qualified State tuition programs under section 529 would be effective for distributions made in taxable years beginning after December 31, 2000. In the case of a qualified tuition program established and maintained by an entity other than a State or agency or instrumentality thereof, the proposal allowing an exclusion from gross income for certain distributions would be effective for distributions made in taxable years beginning after December 31, 2003. The proposal coordinating distributions from qualified tuition programs with the HOPE and Lifetime Learning credits would be effective for distributions made after December 31, 2000. The proposals modifying the definition of qualified higher education expenses, allowing rollovers for the same beneficiary, and including first cousins as a member of the family would be effective for taxable years beginning after December 31, 2000.

C. Eliminate Tax on Awards Under National Health Service Corps Scholarship Program, F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program, National Institutes of Health Undergraduate Scholarship Program, and Certain State-sponsored Scholarship Programs

Present Law

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.

Section 117(c) specifically provides that the exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

The National Health Service Corps Scholarship Program (the “NHSC Scholarship Program”), the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the “Armed Forces Scholarship Program”), and the National Institutes of Health Undergraduate Scholarship Program (the “NIH Scholarship Program”) provide education awards to participants on condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health-care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. The National Institutes of Health Undergraduate Scholarship Program (the “NIH Scholarship Program”) awards scholarships to students from disadvantaged backgrounds interested in pursuing a career in biomedical research. In exchange, the recipients must work for the National Institutes of Health after graduation. Several States also provide a limited number of scholarships to students in health professions who are obligated to work in underserved areas for a period of time after graduation. Because the recipients of scholarships in all of these programs are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

Description of Proposal

The proposal would provide that amounts received by an individual under the NHSC Scholarship Program, the Armed Forces Scholarship Program, the NIH Scholarship Program, or any State-sponsored health scholarship program determined by the Secretary of the Treasury to have substantially similar objectives to these programs would be eligible for tax-free treatment as qualified scholarships under section 117, without regard to any service obligation by the recipient. As with other qualified scholarships under section 117, the tax-free treatment would not apply to amounts received by students for regular living expenses, including room and board.

Effective Date

The proposal would be effective for education awards received under the NHSC Scholarship Program, the Armed Forces Scholarship Program, and the NIH Scholarship Program after December 31, 1993. The proposal would be effective for education awards received under any State-sponsored health scholarship program designated by the Secretary of the Treasury after December 31, 1999.

D. Liberalize Tax-Exempt Bond Arbitrage Rebate Exceptions for Public School Construction Bonds

Present Law

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Like other activities carried out and paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than necessary, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined “temporary periods”) before funds are needed for the purpose of the borrowing or on specified types of investments (e.g., “reasonably required reserve or replacement funds”). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government.

The Code includes three exceptions applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance. In the case of governmental bonds (including bonds to finance public schools) the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months for construction proceeds. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.

Third, governmental bonds issued by “small” governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than \$5 million of tax-exempt governmental bonds in a calendar year. The \$5 million limit is increased to \$10 million if at least \$5 million of the bonds are used to finance public schools.

Description of Proposals

Liberalize construction bond expenditure rule for governmental bonds for public schools

The present-law 24-month expenditure exception to the arbitrage rebate requirement would be liberalized for certain public school bonds. Under the proposal, no rebate would be required with respect to earnings on available construction proceeds of public school bonds if the proceeds were spent within 48 months after the bonds were issued and the following intermediate spending levels were satisfied:

12 months	At least 10 percent
24 months	At least 30 percent
36 months	At least 60 percent
48 months	100 percent (less present-law retainage amounts which must be spent within 60 months of issuance)

Increase amount of bonds that may be issued by governments qualifying for the “small governmental unit” arbitrage rebate exception

The additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirement would be increased from \$5 million to \$10 million. Thus, these governmental units could issue up to \$15 million of governmental bonds in a calendar year, provided that at least \$10 million of the bonds were used to finance construction of public schools.

Effective Dates

The liberalized expenditure exception for public school construction bonds would be effective for bonds issued after December 31, 1999.

The increase in the small governmental unit arbitrage rebate exception would be effective for calendar years beginning after December 31, 1999.

E. Eliminate 60-month Limit on Student Loan Interest Deduction

Present Law

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit (sec. 221). The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include nonmandatory payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for certain costs of attendance (including room and board) of a student (who may be the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred) who is enrolled in a degree program on at least a half-time basis at (1) an accredited post-secondary educational institution defined by reference to section 481 of the Higher Education Act of 1965, or (2) an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The maximum allowable deduction per taxpayer return is \$1,500 in 1999, \$2,000 in 2000, and \$2,500 in 2001 and thereafter.²² The deduction is phased out ratably for individual taxpayers with modified adjusted gross income of \$40,000-\$55,000 and \$60,000-\$75,000 for joint returns. The income ranges will be indexed for inflation after 2002.

Description of Proposal

The proposal would repeal both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that nonmandatory payments of interest are not deductible.

Effective Date

The proposal would be effective for interest paid on qualified education loans after December 31, 1999.

²² The maximum allowable deduction for 1998 was \$1,000.

V. HEALTH CARE TAX RELIEF PROVISIONS

A. Above-the-Line Deduction for Health Insurance Expenses

Present Law

Under present law, the tax treatment of health insurance expenses depends on the individual's circumstances. Self-employed individuals may deduct a portion of health insurance expenses for the individual and his or her spouse and dependents. The deductible percentage of health insurance expenses of a self-employed individual is 60 percent in 1999 through 2001; 70 percent in 2002; and 100 percent in 2003 and thereafter. The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. The deduction applies to qualified long-term care insurance premiums treated as medical expenses under the itemized deduction for medical expenses, described below.

Employees can exclude from income 100 percent of employer-provided health insurance.

Individuals who itemize deductions may deduct their health insurance expenses only to the extent that the total medical expenses of the individual exceed 7.5 percent of adjusted gross income (sec. 213). Subject to certain dollar limitations, premiums for qualified long-term care insurance are treated as medical expenses for purposes of the itemized deduction for medical expenses (sec. 213). The amount of qualified long-term care insurance premiums that may be taken into account for 1999 is as follows: \$210 in the case of an individual 40 years old or less; \$400 in the case of an individual who is more than 40 but not more than 50; \$800 in the case of an individual who is more than 50 but not more than 60; \$2,120 in the case of an individual who is more than 60 but not more than 70; and \$2,660 in the case of an individual who is more than 70. These dollar limits are indexed for inflation.

Description of Proposal

The proposal would provide an above-the-line deduction for a percentage of the amount paid during the year for insurance which constitutes medical care (as defined under sec. 213, other than long-term care insurance treated as medical care under sec. 213) for the taxpayer and his or her spouse and dependents.²³ The deductible percentage would be: 25 percent in 2001; 40 percent in 2002; 50 percent in 2003 through 2006; 75 percent in 2007; and 100 percent in 2008 and thereafter.

²³ The deduction would only apply to health insurance that constitutes medical care; it would not apply to medical expenses. The deduction would apply to self-insured arrangements (provided such arrangements constitute insurance, e.g., there is appropriate risk-shifting) and coverage under employer plans treated as insurance under section 104. Another provision of the proposal would provide a similar deduction for qualified long-term care insurance expenses.

The deduction would not be available to an individual for any month in which the individual is covered under an employer-sponsored health plan if the at least 50 percent of the cost of the coverage is paid or incurred by the employer.²⁴ For purposes of this rule, any amounts amounts excludable from the gross income of the employee under the exclusion for employer-provided health coverage would be treated as paid or incurred by the employer; thus, for example, health insurance purchased by an employee through a cafeteria plan with salary reduction amounts would be considered to be paid for by the employer.²⁵ In determining whether the 50-percent threshold is met, all health plans of the employer in which the employee participates would be treated as a single plan. If the employer pays for less than 50 percent of the cost of all health plans in which the individual participates, the deduction would be available only with respect to each plan with respect to which the employer subsidy is less than 50 percent. Cost would be determined as under the health care continuation rules. The following examples illustrate the application of the 50-percent rule.

Example 1: Employee A participates in an employer-sponsored health plan. The annual cost for single coverage is \$3,000, and the annual additional cost for coverage for A's spouse and dependents is \$1,000. The employer pays 100 percent of the cost of individual coverage, but does not pay any additional amount for family coverage. A chooses family coverage. The total amount the employer pays for the insurance is \$3,000, which is 75 percent of the total cost of the coverage (\$4,000). Thus, the deduction would not be available.

Example 2: Employee B participates in two employer-sponsored health plans. One plan provides major medical coverage. The cost of this plan is \$2,000 per year. The employer pays for half the cost of this plan (\$1,000). The second plan provides only dental coverage. The cost of the dental plan is \$300 per year, which is paid by the employee. The total cost of the health plans in which B participates is \$2,300. The employer pays for less than 50 percent of this total cost. B may deduct the cost of the dental coverage; but not B's share of the premium for the major medical plan, because the employer pays for at least 50 percent of the cost of that plan.

The deduction would not be available to individuals enrolled in Medicare, Medicaid, the Federal Employees Benefit Program,²⁶ Champus, VA, Indian Health Service, or Children's Health Insurance programs.

Under the proposal, employers would be required to report information regarding employee

²⁴ This rule would be applied separately with respect to qualified long-term care insurance.

²⁵ Excludable employer contributions to a health flexible spending arrangement or medical savings account (including salary reduction contributions) would also be considered amounts paid by the employer for health insurance that constitutes medical care.

²⁶ The deduction would be available with respect to premiums for health care continuation coverage, provided the requirements for the deduction are otherwise met.

health care coverage, such as whether the employee is covered under a health insurance or long-term care insurance plan, and the total cost of such coverage.

Effective Date

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

B. Provisions Relating to Long-term Care Insurance

Present Law

Tax treatment of health insurance and long-term care insurance

Under present law, the tax treatment of health insurance expenses depends on the individual's circumstances. Self-employed individuals may deduct a portion of health insurance expenses for the individual and his or her spouse and dependents. The deductible percentage of health insurance expenses of a self-employed individual is 60 percent in 1999 through 2001; 70 percent in 2002; and 100 percent in 2003 and thereafter. The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. The deduction applies to qualified long-term care insurance premiums treated as medical expenses under the itemized deduction for medical expenses, described below.

Employees can exclude from income 100 percent of employer-provided health insurance or qualified long-term care insurance.

Individuals who itemize deductions may deduct their health insurance expenses only to the extent that the total medical expenses of the individual exceed 7.5 percent of adjusted gross income (sec. 213). Subject to certain dollar limitations, premiums for qualified long-term care insurance are treated as medical expenses for purposes of the itemized deduction for medical expenses (sec. 213). The amount of qualified long-term care insurance premiums that may be taken into account for 1999 is as follows: \$210 in the case of an individual 40 years old or less; \$400 in the case of an individual who is more than 40 but not more than 50; \$800 in the case of an individual who is more than 50 but not more than 60; \$2,120 in the case of an individual who is more than 60 but not more than 70; and \$2,660 in the case of an individual who is more than 70. These dollar limits are indexed for inflation.

Cafeteria plans

Under present law, compensation generally is includible in gross income when actually or constructively received. An amount is constructively received by an individual if it is made available to the individual or the individual has an election to receive such amount. Under one exception to the general principle of constructive receipt, amounts are not included in the gross income of a participant in a cafeteria plan described in section 125 of the Code solely because the participant may elect among cash and certain employer-provided qualified benefits under the plan. This constructive receipt exception is not available if the individual is permitted to revoke a benefit election during a period of coverage in the absence of a change in family status or certain other events.

In general, qualified benefits are certain specified benefits that are excludable from an employee's gross income by reason of a specific provision of the Code. Thus, employer-provided

accident or health coverage, group-term life insurance coverage (whether or not subject to tax by reason of being in excess of the dollar limit on the exclusion for such insurance), and benefits under dependent care assistance programs may be provided through a cafeteria plan. The cafeteria plan exception from the principle of constructive receipt generally also applies for employment tax (FICA and FUTA) purposes.²⁷

Long-term care insurance cannot be provided under a cafeteria plan.

Flexible spending arrangements

A flexible spending arrangement (“FSA”) is a reimbursement account or other arrangement under which an employer pays or reimburses employees for medical expenses or certain other nontaxable employer-provided benefits, such as dependent care. An FSA may be part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance. Qualified long-term care services cannot be provided through an FSA.

Description of Proposal

Deduction for qualified long-term care insurance expenses

The proposal would provide an above-the-line deduction for a percentage of the amount paid during the year for long-term care insurance which constitutes medical care (as defined under sec. 213) for the taxpayer and his or her spouse and dependents.²⁸ The deductible percentage would be: 25 percent in 2001; 40 percent in 2002; 50 percent in 2003 through 2006; 75 percent in 2007; and 100 percent in 2008 and thereafter.

The deduction would not be available to an individual for any month in which the individual is covered under an employer-sponsored health plan if at least 50 percent of the cost of the coverage is paid or incurred by the employer.²⁹ For purposes of this rule, an employer any amounts excludable from the gross income of the employee with respect to qualified long-term care insurance would be treated as paid or incurred by the employer. In determining whether the 50-

²⁷ Elective contributions under a qualified cash or deferred arrangement that is part of a cafeteria plan are subject to employment taxes.

²⁸The deduction would only apply to insurance that constitutes medical care; it would not apply to long-term care insurance expenses. The deduction would apply to self-insured arrangements (provided such arrangements constitute insurance, e.g., there is appropriate risk-shifting) and coverage under employer plans treated as insurance under section 104. Another provision of the proposal would provide a similar deduction for health insurance expenses.

²⁹This rule would be applied separately with respect to health insurance.

percent threshold is met, all plans of the employer providing long-term care in which the employee participates would be treated as a single plan. If the employer pays less than 50 percent of the cost of all long-term care plans in which the individual participates, the deduction would be available only with respect to each plan with respect to which the employer pays for less than 50 percent of the cost. Cost would be determined as under the health care continuation rules.

Under the proposal, employers would be required to report information regarding employee health care coverage, such as whether the employee is covered under a health insurance or long-term care insurance plan, and the total cost of such coverage.

The proposal would provide that qualified long-term care insurance is a qualified benefit under a cafeteria plan. The proposal would also provide that qualified long-term care services can be provided under an FSA.³⁰

Effective Date

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

³⁰Excludable employer contributions to a flexible spending arrangement or a cafeteria plan for qualified long-term care insurance or services would be considered an amount paid by the employer for long-term care insurance.

C. Extend Availability of Medical Savings Accounts

Present Law

In general

Within limits, contributions to a medical savings account (“MSA”)³¹ are deductible in determining AGI if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not currently taxable. Distributions from an MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15-percent tax unless the distribution is made after age 65, death, or disability.

Eligible individuals

MSAs are available to employees covered under an employer-sponsored high deductible plan of a small employer and self-employed individuals regardless of the size of the entity for which the individual performs services.³² An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year.

In order for an employee of a small employer to be eligible to make MSA contributions (or to have employer contributions made on his or her behalf), the employee must be covered under an employer-sponsored high deductible health plan (see the definition below) and must not be covered under any other health plan (other than a plan that provides certain permitted coverage, described below). In the case of an employee, contributions can be made to an MSA either by the individual or by the individual's employer. However, an individual is not eligible to make contributions to an MSA for a year if any employer contributions are made to an MSA on behalf of the individual for the year. Similarly, if the individual's spouse is covered under the high deductible plan covering such individual and the spouse's employer makes a contribution to an MSA for the spouse, the individual may not make MSA contributions for the year.

Similarly, in order to be eligible to make contributions to an MSA, a self-employed individual must be covered under a high deductible health plan and no other health plan (other than

³¹ In general, an MSA is a trust or custodial account created exclusively for the benefit of the account holder and is subject to rules similar to those applicable to individual retirement arrangements. The trustee of an MSA can be a bank, insurance company, or other person who demonstrates to the satisfaction of the Secretary that the manner in which such person will administer the trust will be consistent with applicable requirements.

³² Self-employed individuals include more than 2-percent shareholders of S corporations who are treated as partners for purposes of fringe benefit rules pursuant to section 1372.

a plan that provides certain permitted coverage, described below). A self-employed individual is not an eligible individual (by reason of being self-employed) if the high deductible plan under which the individual is covered is established or maintained by an employer of the individual (or the individual's spouse).

An individual with other coverage in addition to a high deductible plan is still eligible for an MSA if such other coverage is certain permitted insurance or is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care. Permitted insurance is: (1) Medicare supplemental insurance; (2) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary may prescribe by regulations; (3) insurance for a specified disease or illness; and (4) insurance that provides a fixed payment for hospitalization.

If a small employer with an MSA plan ceases to become a small employer (i.e., exceeds the 50-employee limit), then the employer (and its employees) can continue to establish and make contributions to MSAs (including contributions for new employees and employees that did not previously have an MSA) until the year following the first year in which the employer has more than 200 employees. After that, those employees who had an MSA (to which individual or employer contributions were made in any year) can continue to make contributions (or have contributions made on their behalf) even if the employer has more than 200 employees.

Tax treatment of and limits on contributions

Individual contributions to an MSA are deductible (within limits) in determining adjusted gross income (i.e., "above the line"). In addition, employer contributions are excludable from gross income and wages for employment tax purposes (within the same limits), except that this exclusion does not apply to contributions made through a cafeteria plan. No deduction is allowed to any individual for MSA contributions if such individual is a dependent on another taxpayer's tax return.

In the case of a self-employed individual, the deduction cannot exceed the individual's earned income from the trade or business with respect to which the high deductible plan is established. In the case of an employee, the deduction cannot exceed the individual's compensation attributable to the employer sponsoring the high deductible plan in which the individual is enrolled.

The maximum annual contribution that can be made to an MSA for a year is 65 percent of the deductible under the high deductible plan in the case of individual coverage and 75 percent of the deductible in the case of family coverage.

Contributions for a year can be made until the due date for the individual's tax return for the year (determined without regard to extensions).

If an employer provides high deductible health plan coverage coupled with an MSA to

employees and makes employer contributions to the MSAs during a calendar year, the employer must make available a comparable contribution on behalf of all employees with comparable coverage during the same coverage period in the calendar year. Contributions are considered comparable if they are either of the same dollar amount or the same percentage of the deductible under the high deductible plan. The comparability rule does not restrict contributions that can be made to an MSA by a self-employed individual.

If employer contributions do not comply with the comparability rule during a calendar year, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to MSAs of the employer for the year. In the case of a failure to comply with the comparability rule which is due to reasonable cause and not to willful neglect, the Secretary may waive part or all of the tax imposed to the extent that the payment of the tax would be excessive relative to the failure involved.

Definition of high deductible plan

A high deductible plan is a health plan with an annual deductible of at least \$1,550 and no more than \$2,300 in the case of individual coverage and at least \$3,050 and no more than \$4,600 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than \$3,050 in the case of individual coverage and no more than \$5,600 in the case of family coverage.³³ A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by State law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage (as described above). In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

Tax treatment of MSAs

Earnings on amounts in an MSA are not currently includible in income.

Taxation of distributions

Distributions from an MSA for the medical expenses of the individual and his or her spouse or dependents generally are excludable from income.³⁴ However, in any year for which a contribution is made to an MSA, withdrawals from an MSA maintained by that individual generally are excludable from income only if the individual for whom the expenses were incurred was

³³ These dollar amounts are for 1999. These amounts are indexed for inflation in \$50 increments.

³⁴ This exclusion does not apply to expenses that are reimbursed by insurance or otherwise.

covered under a high deductible plan for the month in which the expenses were incurred.³⁵ This rule is designed to ensure that MSAs are in fact used in conjunction with a high deductible plan, and that they are not primarily used by other individuals who have health plans that are not high deductible plans.

For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include expenses for insurance other than long-term care insurance, premiums for health care continuation coverage, and premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law.

Distributions that are not used for medical expenses are includible in income. Such distributions are also subject to an additional 15-percent tax unless made after age 65, death, or disability.

Cap on taxpayers utilizing MSAs

The number of taxpayers benefitting annually from an MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the 4-year pilot period 1997-2000, only those individuals who (1) made an MSA contribution or had an employer MSA contribution for the year or a preceding year (i.e., are active MSA participants) or (2) are employed by a participating employer, would be eligible for an MSA contribution. In determining whether the threshold for any year has been exceeded, MSAs of individuals who were not covered under a health insurance plan for the six month period ending on the date on which coverage under a high deductible plan commences would not be taken into account.³⁶ However, if the threshold level is exceeded in a year, previously uninsured individuals would be subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an MSA contribution for a year following a cut-off year unless they are an active MSA participant (i.e., had an MSA contribution for the year or a preceding year) or are employed by a participating employer.

The number of MSAs established has not exceeded the threshold level.

End of MSA pilot program

After December 31, 2000, no new contributions may be made to MSAs except by or on behalf of individuals who previously had MSA contributions and employees who are employed by

³⁵ The exclusion still applies to expenses for continuation coverage or coverage while the individual is receiving unemployment compensation, even if for an individual who is not an eligible individual.

³⁶ Permitted coverage, as described above, does not constitute coverage under a health insurance plan for this purpose.

a participating employer. An employer is a participating employer if (1) the employer made any MSA contributions for any year to an MSA on behalf of employees or (2) at least 20 percent of the employees covered under a high deductible plan made MSA contributions of at least \$100 in the year 2000.

Self-employed individuals who made contributions to an MSA during the period 1997-2000 also may continue to make contributions after 2000.

Description of Proposal

Eligible individuals and cap on MSAs

The proposal would expand availability of MSAs to include all employees covered under a high deductible plan of the employer. Self-employed individuals would continue to be eligible to contribute to an MSA.

The proposal would also eliminate the cap on the number of taxpayers that can benefit annually from MSA contributions.

Definition of high deductible plan and limits on contributions

The proposal would modify the definition of a high deductible plan by decreasing the lower threshold for the annual deductible. Thus, under the proposal, a high deductible plan would mean a plan with an annual deductible of at least \$1,000 and not more than \$2,300 (indexed) in the case of individual coverage and at least \$2,000 and not more than \$4,600 (indexed) in the case of family coverage. The limits on out-of-pocket expenses would be the same as under present law.

The proposal would increase the amount of deductible (or excludable) contributions to an MSA to 100 percent of the deductible under the high deductible plan. The proposal would also allow an individual to make deductible contributions to an MSA even if the individual's employer also made contributions. The proposal would provide that MSAs could be offered as part of a cafeteria plan. The total contributions could not exceed 100 percent of the deductible under the high deductible plan.

End of MSA pilot program

The proposal would make the provisions relating to MSAs permanent.

Effective Date

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

D. Additional Personal Exemption for Caretakers

Present Law

Generally, present law does not provide for an additional personal exemption based solely on the custodial care of parents or grandparents. However, taxpayers with dependent parents generally are able to claim a personal exemption for each of these dependents, if they satisfy five tests: (1) a member of household or relationship test; (2) a citizen test; (3) a joint return test; (4) a gross income test; and (5) a support test. The taxpayer is also required to list each dependent's tax identification number (the TIN") on the tax return.

The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is \$2,750 for 1999, and is adjusted annually for inflation. The total amount of the personal exemptions is phased out for taxpayers with AGI in excess of \$126,600 for single taxpayers, \$158,300 for heads of household, and \$189,950 for married couples filing joint returns. For 1999, the point at which a taxpayer's personal exemptions are completely phased-out is \$249,100 for single taxpayers, \$280,800 for heads of households, and \$312,450 for married couples filing joint returns.

Description of Proposal

The proposal would provide taxpayers who maintain a household including one or more "qualified persons" with an additional personal exemption in computing income tax liability for each qualified person.

To be a "qualified person," an individual would have to satisfy: (1) a relationship test, (2) a residency test, (3) a disability test, and (4) an identification test. The individual would satisfy the relationship test if the individual was the father or mother of: (a) the taxpayer, (b) the taxpayer's spouse, or (c) a former spouse of the taxpayer. A stepfather, stepmother, and ancestors of the father or mother would be treated as a father or mother for these purposes.

An individual would satisfy the residency test if the individual had the same principal place of abode as the taxpayer for the taxpayer's entire taxable year.

An individual would satisfy the disability test if the individual was certified before the due date of the return for the taxable year (without extensions) by a licensed physician as being unable for period of at least 180 consecutive days to perform at least 2 activities of daily living ("ADLs") without substantial assistance from another individual, due to a loss of functional capacity. As with the present-law rules relating to long-term care, ADLs would be eating, toileting, transferring, bathing, dressing, and continence. Substantial assistance would include hands-on assistance (that is, the physical assistance of another person without which the individual is unable to perform the ADL) and stand-by assistance (that is, the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention, injury to the individual when

performing the ADL).

As an alternative to the 2-ADL test described above, an individual would be considered to have long-term care needs if he or she were certified by a licensed physician as (a) requiring substantial supervision for at least 6 months to be protected from threats to health and safety due to severe cognitive impairment and (b) being unable for at least 6 months to perform at least one or more ADLs or to engage in age appropriate activities as determined under regulations prescribed by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services.

An individual would satisfy the identification test if the individual's name and taxpayer identification number (TIN) were included on the taxpayer's return for the taxable year.

The proposal would provide that a taxpayer is treated as maintaining a household for any period only if over one-half of the cost of maintaining a household for such period is furnished by such taxpayer or, if such taxpayer is married, by such taxpayer and the taxpayer's spouse. The proposal would also provide that taxpayers who are married at the end of the taxable year must file a joint return to receive the credit unless they lived apart from their respective spouse for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for the qualified person for the entire taxable year and (2) furnished over one-half of the cost of maintaining that household in that taxable year. Finally, the proposal would provide that a taxpayer legally separated from the taxpayer's spouse under a decree of divorce or of separate maintenance would not be considered married for purposes of this provision.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

E. Expand Human Clinical Trials Expenses Qualifying for the Orphan Drug Tax Credit

Present Law

Taxpayers may claim a 50-percent credit for expenses related to human clinical testing of drugs for the treatment of certain rare diseases and conditions, generally those that afflict less than 200,000 persons in the United States. Qualifying expenses are those paid or incurred by the taxpayer after the date on which the drug is designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration (“FDA”) in accordance with section 526 of the Federal Food, Drug, and Cosmetic Act.

Description of Proposal

The proposal would expand qualifying expenses to include those expenses related to human clinical testing paid or incurred after the date on which the taxpayer files an application with the FDA for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder. As under present law, the credit may only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the FDA in accordance with section 526 of such Act.

Effective Date

The provision would be effective for expenditures paid or incurred after December 31, 1999.

F. Add Certain Vaccines Against Streptococcus Pneumoniae to the List of Taxable Vaccines

Present Law

A manufacturer's excise tax is imposed at the rate of 75 cents per dose (sec. 4131) on the following vaccines routinely recommended for administration to children: diphtheria, pertussis, tetanus, measles, mumps, rubella, polio, HIB (haemophilus influenza type B), hepatitis B, varicella (chicken pox), and rotavirus gastroenteritis. The tax applies to any vaccine that is a combination of vaccine components equals 75 cents times the number of components in the combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Description of Proposal

The proposal would add conjugated streptococcus pneumoniae vaccines to the list of taxable vaccines.

In addition, the General Accounting Office ("GAO") would be directed to report to the House Committee on Ways and Means and the Senate Committee on Finance on the operation and management of expenditures from the Vaccine Injury Compensation Trust Fund and to advise the Committees on the adequacy of the Vaccine Injury Compensation Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program. The GAO would report its findings to the House Committee on Ways and Means and the Senate Committee on Finance within one year from the date of enactment.

Effective Date

The proposal would be effective for vaccine purchases beginning on the day after the date on which the Centers for Disease Control make final recommendation for routine administration of conjugated streptococcus pneumoniae vaccines to children. No floor stocks tax would be collected for amounts held for sale on that date.

VI. DEATH TAX RELIEF PROVISIONS

A. Phase in Repeal of Estate, Gift, and Generation-Skipping Taxes

Present Law

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. The gift tax and the estate tax are unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. The unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over \$3 million. In addition, a 5-percent surtax is imposed on cumulative taxable transfers between \$10 million and the amount necessary to phase out the benefits of the graduated rates.

A unified credit is available with respect to taxable transfers by gift and at death. The unified credit amount effectively exempts from tax a total of \$650,000 in 1999, \$675,000 in 2000 and 2001, \$700,000 in 2002 and 2003, \$850,000 in 2004, \$950,000 in 2005, and \$1 million in 2006 and thereafter.

A generation-skipping transfer (“GST”) tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations, and taxable distributions. The GST tax is imposed at a flat rate of 55 percent (i.e., the top estate and gift tax rate) on cumulative generation-skipping transfers in excess of \$1 million.

The basis of property acquired or passing from a decedent is its fair market value on the date of the decedent’s death (or, if the alternative valuation date is elected, the earlier of six months or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of any income on the appreciation of the property that occurred prior to the decedent’s death, and it has the effect of eliminating any tax benefit from any unrealized loss.

Description of Proposal

Beginning in 2009, the estate, gift, and GST taxes would be repealed, after which a carryover basis regime would take effect for transfers of property at death. Transfers to surviving spouses would continue to receive a step up in basis. Assets from estates with a total value of \$2 million or less also would receive a step up in basis; however, the carryover basis regime would be phased in for estates valued in excess of \$1.3 million and not over \$2 million.

Beginning in 2001, the unified credit would be replaced with a unified exemption, the 5 percent surtax (which phases out the graduated rates) and the rates in excess of 50 percent would be repealed, and the estate, gift, and GST tax rates would be reduced each year until they are repealed in 2009.

Phaseout and repeal of estate, gift, and GST taxes

Beginning in 2001, the top estate and gift tax rates above 50 percent would be repealed, as would the 5-percent surtax, which phases out the graduated rates. Beginning in 2002 and through 2004, each of the rates of tax would be reduced by 1 percentage point. Beginning in 2005 and through 2008, each of the rates of tax would be reduced by 2 percentage points. The highest estate and gift tax rate in effect for a given year would be the GST tax rate for that year. The reduction in estate and gift tax rates would be coordinated with the income tax rates such that the highest estate and gift tax rate (and, thus, the GST tax rate) would not be reduced below the top individual tax rate, which, under the broad-based income tax relief proposal (in Part I), would be 38.6 percent (in 2002 through 2004), 37.6 percent (in 2005 through 2007), and 35.6 percent (in 2008). The lower estate and gift tax rates would not be reduced below the lowest individual tax rate, which, under the broad-based income tax relief proposal, would be 14.6 percent (in 2002 through 2004), 14.3 percent (in 2005 through 2007), and 13.9 percent (in 2008). Beginning in 2002 and through 2008, the State tax credit rates would be reduced in proportion to the reduction in the estate and gift tax rates.

Beginning in 2009, the estate, gift, and GST taxes would be repealed.

Replace unified credit with unified exemption

Beginning in 2001, the unified credit would be replaced with a unified exemption amount. The unified exemption amount would be determined for the following calendar years: in 2001, \$675,000; in 2002 and 2003, \$700,000; in 2004, \$850,000; in 2005, \$950,000; and in 2006 and thereafter, \$1,000,000. For decedents who are not residents and not citizens of the United States, the exemption would be the greater of (1) \$60,000 or (2) that portion of \$175,000 which the value of that part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of the decedent's entire gross estate wherever situated.

Carryover basis

Beginning in 2009, after the estate, gift, and GST taxes have been repealed, a carryover basis regime would take effect. Recipients of property transferred during the transferor's life or at the decedent transferor's death would receive the transferor's basis in the property.

Transfers to surviving spouses would continue to receive step up in basis. Assets from estates with a total value of \$2 million or less also would receive a step up in basis; however, the carryover basis regime would be phased in for estates valued in excess of \$1.3 million and not over \$2 million. For transfers from these estates, the amount of the step up from basis to fair market value of each appreciated asset would be reduced, proportionately, by the amount which bears the same ratio to such step up as the excess over \$1.3 million but not over \$2 million bears to \$700,000.

Effective Date

The unified credit would be replaced with a unified exemption, the 5-percent surtax would be repealed, and the rates in excess of 50 percent would be repealed for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2000.

The phaseout of the estate and gift tax rates and phaseout of the State tax credit would occur in 2002 through 2008.

The estate, gift, and GST taxes would be repealed and the carryover basis regime would take effect for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2008.

B. Modify Generation-Skipping Tax Rules

1. Deemed allocation of the generation-skipping transfer (“GST”) tax exemption to lifetime transfers to trusts that are not direct skips

Present Law

A GST tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations, and taxable distributions. An exemption of \$1 million (indexed beginning in 1999) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer (55 percent under present law) multiplied by the “inclusion ratio.” The inclusion ratio with respect to any property transferred in a generation-skipping transfer indicates the amount of “GST exemption” allocated to a trust. The allocation of GST exemption reduces the 55-percent tax rate on a generation-skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused GST exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual may elect out of the automatic allocation for lifetime direct skips.

For lifetime transfers made to a trust that are not direct skips, the transferor must allocate GST exemption--the allocation is not automatic. If GST exemption is allocated on a timely-filed gift tax return, then the portion of the trust which is exempt from GST tax is based on the value of the property at the time of the transfer. If, however, the allocation is not made on a timely-filed gift tax return, then the portion of the trust which is exempt from GST tax is based on the value of the

property at the time the allocation of GST exemption was made.

Treas. Reg. 26.2632-1(d) further provides that any unused GST exemption, which has not been allocated to transfers made during an individual's life, is automatically allocated on the due date for filing the decedent's estate tax return. Unused GST exemption is allocated pro rata on the basis of the value of the property as finally determined for estate tax purposes, first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused GST exemption is allocated pro rata, on the basis of the estate tax value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made.

Description of Proposal

The proposal would provide automatic allocation of GST exemption to transfers made during life that are "indirect skips." An indirect skip means any transfer of property (that is not a direct skip) subject to the gift tax that is made to a GST trust.

A GST trust is defined as a trust that could have a generation-skipping transfer with respect to the transferor (e.g., a taxable termination or taxable distribution), unless:

- the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons (a) before the date that the individual attains age 46, (b) on or before 1 or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (c) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains age 46;
- the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals;
- the trust instrument provides that, if 1 or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25 percent of the trust corpus either must be distributed to the estate or estates of 1 or more of such individuals or is subject to a general power of appointment exercisable by 1 or more of such individuals;
- the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer;
- the trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable unitrust; or

- the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's GST exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

An individual may elect not to have the automatic allocation rules apply to an indirect skip, and such elections will be deemed timely if filed on a timely-filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as may be prescribed by the Treasury Secretary. An individual may elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust and may elect to treat any trust as a GST trust with respect to any or all transfers made by the individual to such trust, and such election may be made on a timely-filed gift tax return for the calendar year for which the election is to become effective.

Effective Date

The proposal would apply to transfers subject to estate or gift tax made after December 31, 1999, and to estate tax inclusion periods ending after December 31, 1999.

2. Retroactive allocation of the GST tax exemption

Present Law

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates GST tax exemption to a trust prior to the taxable termination or taxable distribution, GST tax may be avoided.

A transferor will likely not allocate GST tax exemption to a trust that the transferor expects will benefit only non-skip persons. However, if a taxable termination occurs because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and GST tax exemption had not been allocated to the trust, then GST tax would be due even if the transferor had unused GST tax exemption.

Description of Proposal

The proposal would allow the retroactive allocation of GST exemption when there is an unnatural order of death. Under the provision, if a lineal descendant of the transferor predeceases the transferor, then the transferor may allocate any unused GST exemption to any previous transfer or transfers to the trust on a chronological basis. The proposal would permit a transferor to retroactively allocate GST exemption to a trust where a beneficiary (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. Exemption would be allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined at the value on the date that the relevant property was transferred to trust.

Effective Date

The proposal would apply to deaths of non-skip persons occurring after the date of enactment.

3. Severing of trusts holding property having an inclusion ratio of greater than zero

Present Law

A generation-skipping transfer tax ("GST tax") generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations, and taxable distributions. An exemption of \$1 million (indexed beginning in 1999) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

If the value of transferred property exceeds the amount of the GST exemption allocated to that property, then the GST tax generally is determined by multiplying a flat tax rate equal to the highest estate tax rate (which is currently 55 percent) by the "inclusion ratio" and the value of the taxable property at the time of the taxable event. The "inclusion ratio" is the number one minus the "applicable fraction." The applicable fraction is a fraction calculated by dividing the amount of the GST exemption allocated to the property by the value of the property.

Under Treas. Reg. 26.2654-1(b), a trust may be severed into two or more trusts (e.g., one with an inclusion ratio of zero and one with an inclusion ratio of one) only if (1) the trust is severed according to a direction in the governing instrument or (2) the trust is severed pursuant to the trustee's discretionary powers, but only if certain other conditions are satisfied (e.g., the severance occurs or a reformation proceeding begins before the estate tax return is due). Under current Treasury regulations, however, a trustee cannot sever a trust that is subject to the GST tax after the trust has been created.

Description of Proposal

The proposal would allow a trust to be severed in a “qualified severance.” A qualified severance is defined as the division of a single trust and the creation of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. Under the proposal, a trustee could elect to sever a trust in a qualified severance at any time.

Effective Date

The proposal would be effective for severances of trusts occurring after the date of enactment.

4. Modification of certain valuation rules

Present Law

Under present law, the inclusion ratio is determined using gift tax values for allocations of GST tax exemption made on timely filed gift tax returns. The inclusion ratio generally is determined using estate tax values for allocations of GST tax exemption made to transfers at death. Treas. Reg. 26.2642-5(b) provides that, with respect to taxable terminations and taxable distributions, the inclusion ratio becomes final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor’s estate.

Description of Proposal

The proposal would provide that, in connection with timely and automatic allocations of GST tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a GST tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Effective Date

The provision would be effective as though included in the amendments made by section 1431 of the Tax Reform Act of 1986.

5. Relief from late elections

Present Law

Under present law, an election to allocate GST tax exemption to a specific transfer may be made at any time up to the time for filing the transferor's estate tax return. If an allocation is made on a gift tax return filed timely with respect to the transfer to trust, then the value on the date of transfer to trust is used for determining GST tax exemption allocation. However, if the allocation relating to a specific transfer is not made on a timely-filed gift tax return, then the value on the date of allocation must be used. There is no statutory provision allowing relief for an inadvertent failure to make an election on a timely-filed gift tax return to allocate GST tax exemption.

Description of Proposal

The proposal would authorize and direct the Treasury Secretary to grant extensions of time to make the election to allocate GST tax exemption and to grant exceptions to the time requirement. If such relief were granted, then the value on the date of transfer to trust would be used for determining GST tax exemption allocation.

In determining whether to grant relief for late elections, the Treasury Secretary would be directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) would be treated as if not expressly prescribed by statute.

Effective Date

The proposal to provide relief from late elections would apply to requests pending on, or filed after, the date of enactment.

6. Substantial compliance

Present Law

Under present law, there is no statutory rule which provides that substantial compliance with the statutory and regulatory requirements for allocating GST tax exemption will suffice to establish that GST tax exemption was allocated to a particular transfer or trust.

Description of Proposal

The proposal would provide that substantial compliance with the statutory and regulatory requirements for allocating GST tax exemption would suffice to establish that GST tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates an intent to have an inclusion ratio of zero with respect to a particular transfer or trust, then so much of the transferor's unused GST tax exemption will be allocated to the extent it produces, when possible, a zero inclusion ratio. In determining whether there has been substantial compliance, all relevant

circumstances would be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

Effective Date

The substantial compliance provisions would take effect on the date of enactment and would apply to allocations made prior to such date for purposes of determining the tax consequences of generation-skipping transfers with respect to which the period of time for filing claims for refund has not expired.³⁷

³⁷ No negative inference is intended with respect to the application of a rule of substantial compliance prior to enactment of this provision.

VII. DISTRESSED COMMUNITIES AND INDUSTRIES PROVISIONS

A. Renewal Community Provisions

Present Law

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (“OBRA 1993”), the Secretaries of Housing and Urban Development (“HUD”) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. Of the nine empowerment zones, six are located in urban areas and three are located in rural areas.³⁸

In general, businesses located in these empowerment zones qualify for the following tax incentives: (1) a 20-percent wage credit for the first \$15,000 of wages paid to a zone resident who works in the empowerment zone; (2) an additional \$20,000 of section 179 expensing for certain property placed in service by an enterprise zone business; and (3) special tax-exempt financing for certain zone facilities. Businesses located in enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the empowerment zones. The tax incentives for empowerment zones and enterprise communities generally remain in effect for ten years.

The Taxpayer Relief Act of 1997 (“1997 Act”) authorized the designation of two new urban empowerment zones³⁹ and 20 additional empowerment zones. The new urban empowerment zones, whose designations take effect on January 1, 2000, are eligible for substantially the same tax incentives as the nine empowerment zones authorized by OBRA 1993 except that the wage credit is phased down beginning in 2005 and expires after 2007. Businesses in the 20 additional empowerment zones are not eligible for the wage credit (but are eligible to receive up to \$20,000 of additional section 179 expensing and to utilize the special tax-exempt financing benefits).

Description of Proposal

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

Designation process

³⁸ The six urban empowerment zones are located in New York City, Chicago, Atlanta, Detroit, Baltimore, and Philadelphia-Camden (New Jersey). The three rural empowerment zones are located in the Kentucky Highlands (Clinton, Jackson and Wayne counties, Kentucky), Mid-Delta Mississippi (Bolivar, Holmes, Humphreys, Leflore counties, Mississippi), and Rio Grande Valley Texas (Cameron, Hidalgo, Starr, and Willacy counties, Texas).

³⁹ The new urban empowerment zones are located in Los Angeles and Cleveland.

Designation of 20 renewal communities.--Under the proposal, the Secretary of HUD would be authorized to designate up to 20 “renewal communities” from areas nominated by States and local governments. At least four of the designated communities must be in rural areas (defined as areas that are (1) within local government jurisdictions with a population less than 50,000, (2) outside of a metropolitan statistical area, or (3) determined by HUD to be a rural area). The Secretary of HUD would be required to publish (within four months after enactment) regulations describing the selection process; all designations of renewal communities would have to be made within 24 months after such regulations are published. The designation of an area as a renewal community would terminate after December 31, 2007.⁴⁰

Old empowerment zones and enterprise communities could seek additional designation as renewal communities.--The proposal would allow the previously designated empowerment zones and enterprise communities to apply for designation as renewal communities. Priority would be given in the designation of the first ten renewal communities to nominated areas that are empowerment zones or enterprise communities under present law and that otherwise meet the requirements of the proposal for designation as a renewal community. If a previously designated empowerment zone or enterprise community is selected as one of the 20 renewal communities, then the area's designation as an empowerment zone or enterprise community would remain in effect and the same area would also be designated as a renewal community. For such an area obtaining dual-designation status, the special tax incentives available for empowerment zones (or enterprise communities, as the case may be) and for renewal communities would both be available.

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

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

There would be no geographic size or maximum population limitations placed on the designated renewal communities. The proposal merely would require that the boundary of a designated community be “continuous” and that the designated community have a minimum

⁴⁰ The designation would terminate earlier than December 31, 2007, if (1) an earlier termination date is designated by the State or local government, or (2) the Secretary of HUD revokes the designation as of an earlier date.

population of 4,000 if the community is located within a metropolitan statistical area (at least 1,000 in all other cases, or the community must be entirely within an Indian reservation).

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

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

Tax incentives for renewal communities

The following tax incentives generally would be available during the seven-year period beginning January 1, 2001, and ending December 31, 2007.

100-percent capital gain exclusion.--The proposal would provide for a 100 percent capital gains exclusion for capital gain from the sale of a qualified community asset acquired after December 31, 2000, and before January 1, 2008, and held for more than five years. A “qualified community asset” would include: (1) qualified community stock (meaning original-issue stock purchased for cash in a “renewal community business”); (2) a qualified community partnership interest (meaning a partnership interest acquired for cash in a renewal community business); and (3) qualified community business property (meaning tangible real and personal property used in a renewal community business if acquired (or substantially improved) by the taxpayer after December 31, 2000). A “renewal community business” is similar to the present-law definition of an enterprise zone business⁴¹ except that 80 percent of the gross income must be derived from the

⁴¹ An “enterprise zone business” is defined as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community; (2) at least 50 percent of the total gross income is derived from the active conduct of a

conduct of a qualified business within a renewal community. Property would continue to be a “qualified community asset” if sold (or otherwise transferred) to a subsequent purchaser, provided that the property continues to represent an interest in (or is tangible property used in) a renewal community business. The termination of an area's status as a renewal community would not affect whether property is a qualified community asset, but any gain attributable to the period before January 1, 2001, and after December 31, 2007, would not be eligible for the 100-percent capital gains exclusion.

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

The proposal would provide that an FDA is exempt from taxation (other than the unrelated business income tax imposed by present-law section 511). Distributions from an FDA generally would be included in the gross income of the distributee (and would be subject to an additional 10-

“qualified business” within a zone or community; (3) a substantial portion of the business' tangible property is used within a zone or community; (4) a substantial portion of the business' intangible property is used in the active conduct of such business; (5) a substantial portion of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) less than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business (sec. 1397B).

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

percent tax⁴²), but not if the distribution is used exclusively to pay (1) qualified higher educational expenses, (2) qualified first-time homebuyer costs, (3) qualified business capitalization costs⁴³, or (4) qualified medical expenses. Such qualified expenses must be incurred on behalf of the FDA account holder, or the spouse or dependent of the account holder. The proposal also would permit certain qualifying tax-free rollovers of amounts in an FDA into another such account established for the benefit of an individual (or a spouse or dependent). The 10-percent additional tax also would not apply to rollovers.

The proposal also would provide that up to five of the 20 renewal communities also may be designated by the Secretary of HUD as “FDA matching demonstration areas,” with respect to which HUD would match amounts contributed to FDAs, up to \$1,000 per individual per taxable year (with a \$2,000 lifetime cap). The matching grant amounts made under this demonstration program would be excluded from the gross income of the account holder, and no deduction would be allowed for matching grant amounts. A 100-percent excise tax would be imposed on a non-qualified distribution to the extent it is attributable to the HUD matching contributions.

Commercial revitalization deduction.--The proposal would allow each State to allocate an amount of “commercial revitalization deductions” with respect to qualifying expenditures incurred in connection with a qualified revitalization building. The commercial revitalization deduction would be (a) 50 percent of qualifying expenditures for the taxable year in which a qualified revitalization building is placed in service or, at the election of the taxpayer, (b) a ten-percent deduction for qualifying expenditures per year for a 10-year period beginning with the year in which the building is placed in service. A “qualified revitalization expenditure” means the cost (up to \$10 million) of constructing or substantially rehabilitating a building used for commercial purposes in a designated renewal community, including certain land acquisition costs. A commercial revitalization deduction would be in lieu of any depreciation deduction otherwise allowable on account of such expenditure.

Each State would be allowed to allocate no more than \$6 million worth of commercial revitalization deductions to each renewal community located within the State for each calendar year after 2000 and before 2008. The appropriate State agency would make the allocations pursuant to a qualified allocation plan. The qualified allocation plan would (1) set forth the selection criteria to be used to determine priorities as appropriate to local conditions; (2) consider how the building project would contribute to the renewal community and its residents, and (3) provide a procedure that the agency would follow to monitor compliance.

A qualified revitalization building must be located in a renewal community and placed in

⁴² The additional tax would not be imposed, however, if a distribution is made after the account holder reaches age 59½, or is made due to the death or disability of the account holder.

⁴³ As is the case for enterprise zone businesses, a qualified business capitalization cost would not include expenditures incurred for the capitalization of any trade or business described in section 144(c)(6)(B) (e.g., a country club, hot tub facility, or liquor store).

service after December 31, 2000, and before January 1, 2008.

Additional section 179 expensing.--A renewal community business would be allowed an additional \$35,000 of section 179 expensing for qualified renewal property placed in service after December 31, 2000 and before January 1, 2008. If a renewal community business is located in an area that is designated as both an empowerment zone and a renewal community, such business could be allowed an additional \$55,000 of section 179 expensing (i.e., \$20,000 of additional expensing because the area is designated an empowerment zone plus \$35,000 of additional expensing because the area is designated a renewal community). The section 179 expensing allowed to a taxpayer is phased out by the amount by which 50 percent of the cost of qualified renewal property placed in service during the year by the taxpayer exceeds \$200,000. The term “qualified renewal property” is similar to the definition of “qualified zone property” under section 1397C.

Expensing of environmental remediation costs (“brownfields”).--Under the proposal, a renewal community would be treated as a “targeted area” under section 198 permitting expensing of environmental remediation costs. Thus, taxpayers could elect to treat certain environmental remediation expenditures that otherwise would be capitalized as deductible in the year paid or incurred. The expenditure must be incurred in connection with the abatement or control of environmental contaminants, as required by Federal and State law, at a trade or business site located within a designated renewal community. This provision would apply to expenditures incurred after December 31, 2000, and before January 1, 2008.

Extension of work opportunity tax credit (“WOTC”).-- The proposal would make two changes to the WOTC. Beginning in 2001, the proposal would expand the high-risk youth and qualified summer youth categories in the present-law WOTC to include qualified individuals who live in a renewal community. In addition, in the event of the WOTC program were to expire, the proposal would provide a tax credit equal to 15 percent of the qualified first-year wages and 30 percent of the qualified second-year wages (up to the first \$10,000 of wages per year) through December 31, 2007.⁴⁴ For this purpose, “qualified wages” means wages paid by an eligible employer (i.e., an employer engaged in a trade or business in a renewal community) to an individual from one or more of the targeted groups who lives and performs substantially all the work in a renewal community.

Effective Date

Although renewal communities would be designated within 24 months after publication of regulations by HUD, the tax benefits available in renewal communities generally would be effective for the 7-year period beginning January 1, 2001, and ending December 31, 2007.

⁴⁴ The Work Opportunity Tax Credit expired July 1, 1999. A different proposal in this document would extend the Work Opportunity Tax Credit through June 30, 2001.

B. Provide That Federal Production Payments to Farmers Are Taxable in the Year Received

Present law

A taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the "FAIR Act") provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002. Annual payments are made under such contracts at specific times during the Federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15 or January 15 of the fiscal year, at the option of the recipient.⁴⁵ The remaining one-half of the annual payment must be made no later than September 30 of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added section 112(d)(3) to the FAIR Act which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999 can be specified for payment in calendar year 1998.

These options potentially would have resulted in the constructive receipt (and thus inclusion in income) of the payments to which they relate at the time they could have been exercised, whether or not they were in fact exercised. However, section 2012 of the Tax and Trade Relief Extension Act of 1998 provided that the time a production flexibility contract payment under the FAIR Act properly is includible in income is to be determined without regard to either option, effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

Description of Proposal

Any option to accelerate the receipt of any payment under a production flexibility contract which is payable under the FAIR Act, as in effect on the date of enactment of the proposal, would be disregarded in determining the taxable year in which such payment is properly included in gross income. Options to accelerate payments that are enacted in the future would be covered by this proposed rule, provided the payment to which they relate is mandated by the FAIR Act as in effect on the date of enactment of this Act.

⁴⁵ This rule applies to fiscal years after 1996. For fiscal year 1996, this payment was to be made not later than 30 days after the production flexibility contract was entered into.

The proposal would not serve to delay the inclusion of any amount in gross income beyond the taxable period in which the amount is received.

Effective Date

The proposal would be effective on the date of enactment.

C. Allow Net Operating Losses From Oil and Gas Properties To Be Carried Back for Up to Five Years

Present Law

A net operating loss (“NOL”) generally is the amount by which business deductions of a taxpayer exceed business gross income. In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.⁴⁶ A carryback of an NOL results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year. Special NOL carryback rules apply to (1) casualty and theft losses of individual taxpayers, (2) Presidentially declared disasters for taxpayers engaged in a farming business or a small business, (3) real estate investment trusts, (4) specified liability losses, (5) excess interest losses, and (6) farm losses.

Description of Proposal

The proposal would provide a special five-year carryback for certain eligible oil and gas losses. The carryforward period would remain 20 years. An “eligible oil and gas loss” would be defined as the lesser of (1) the amount which would be the taxpayer’s NOL for the taxable year if only income and deductions attributable to operating mineral interests in oil and gas wells were taken into account, or (2) the amount of such net operating loss for such taxable year. In calculating the amount of a taxpayer’s NOL carrybacks, the portion of the NOL that would be attributable to an eligible oil and gas loss would be treated as a separate NOL and taken into account after the remaining portion of the NOL for the taxable year.

Effective Date

The proposal would apply to NOLs arising in taxable years beginning after December 31, 1998.

⁴⁶ A taxpayer could elect to forgo the carryback of an NOL.

D. Increase the Maximum Dollar Amount of Reforestation Expenditures Eligible for Amortization and Credit

Present Law

Amortization of reforestation costs (sec. 194)

A taxpayer may elect to amortize up to \$10,000 (\$5,000 in the case of a separate return by a married individual) of qualifying reforestation expenditures incurred during the taxable year with respect to qualifying timber property. Amortization is taken over 84 months (7 years) and is subject to a mandatory half-year convention.⁴⁷ In the case of an individual, the amortization deduction is allowed in determining adjusted gross income (an above-the-line deduction) rather than as an itemized deduction.

Qualifying reforestation expenditures are the direct costs a taxpayer incurs in connection with the forestation or reforestation of a site by planting or seeding, and include costs for the preparation of the site, the cost of the seed or seedlings, and the cost of the labor and tools (including depreciation of long lived assets such as tractors and other machines) used in the reforestation activity. Qualifying reforestation expenditures do not include expenditures that would otherwise be deductible and do not include costs for which the taxpayer has been reimbursed under a governmental cost sharing program, unless the amount of the reimbursement is also included in the taxpayer's gross income.

Qualifying timber property includes any woodlot or other site that is located in the United States that will contain trees in significant commercial quantities and that is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products. The regulations require that the site consist of at least one acre that is devoted to such activities.⁴⁸ A taxpayer may hold qualifying timber property in fee or by lease. Where the property is held by one person for life with the remainder to another person, the life tenant is considered the owner of the property for this purpose.

Reforestation amortization is subject to recapture as ordinary income on sale of qualifying timber property within 10 years of the year in which the qualifying reforestation expenditures were incurred.⁴⁹

⁴⁷ Under the half-year convention, all reforestation expenditures are considered to be incurred on the first day of the first month of the second half of the taxable year. Thus, an amortization deduction equal to 6/84 of the expenditures for the year is allowed in the first and eighth years and an amortization deduction equal to 1/7 (12/84) of such expenditures is allowed in the second through seventh years.

⁴⁸ Treas. Reg. sec. 1.194-3(a).

⁴⁹ Sec. 1245(b)(7); Treas. Reg. sec. 1.194-1(c).

Reforestation tax credit (sec. 48(b))

A tax credit is allowed equal to 10 percent of the reforestation expenditures incurred during the year that are properly elected to be amortized. An amount allowed as a credit is subject to recapture if the qualifying timber property to which the expenditure relates is disposed of within 5 years.

Description of Proposal

The proposal would increase the amount of reforestation expenditures eligible for 7-year amortization and the reforestation credit from \$10,000 to \$25,000 per taxable year (from \$5,000 to \$12,500 in the case of a separate return by a married individual).

Effective Date

The proposal would be effective for expenditures paid or incurred in taxable years beginning after December 31, 1998.

E. Minimum Tax Relief for the Steel Industry

Present Law

A corporate taxpayer receives a minimum tax credit for any year in which it pays alternative minimum tax. The alternative minimum tax is the excess of tentative minimum tax over regular tax⁵⁰ and generally represents the additional tax a corporate taxpayer is required to pay in any year as a result of the alternative minimum tax system. The minimum tax credit may be used in future years to the extent regular tax exceeds tentative minimum tax. The minimum tax credit may not be used to reduce liability below tentative minimum tax. The credit may be carried forward indefinitely.

For example, a corporate taxpayer has \$1,000 of minimum tax credits available in a year in which its regular tax is \$200 and its tentative minimum tax is \$100. The taxpayer may use \$100 of its minimum tax credits (the excess of regular tax over tentative minimum tax) to reduce its current liability to \$100. The taxpayer would then have \$900 of minimum tax credits available in the following year.

If instead the corporate taxpayer had regular tax of \$100 and tentative minimum tax of \$200, it would not be allowed to use any of its minimum tax credits because there is no excess of regular tax over tentative minimum tax. The taxpayer would have a current liability of \$200 (\$100 of regular tax and \$100 of alternative minimum tax) and would generate an additional \$100 of minimum tax credits, giving it minimum tax credits of \$1100 available for the following year.

Description of Proposal

The proposal would allow minimum tax credits to offset 90 percent of tentative minimum tax⁵¹ in the case of a steel company, in addition to any excess of regular tax over tentative minimum tax. The rules regarding the determination of minimum tax credits would not be changed. A steel company would be a qualified corporation as that term is defined in section 212(g)(1) of the Tax Reform Act of 1986.

For example, under the proposal a steel company has \$1,000 minimum tax credits available in a year in which its regular tax is \$200 and its tentative minimum tax is \$100. The taxpayer may use \$100 (the excess of regular tax over tentative minimum tax) plus \$90 (90% of its tentative minimum tax), for a total of \$190, of its minimum tax credits to reduce its current liability to \$10. The taxpayer would then have \$810 of minimum tax credits available in the following year.

If instead the steel company had regular tax of \$100 and tentative minimum tax of \$200, it would be allowed to use \$180 (90% of its tentative minimum tax) of its minimum tax credits to

⁵⁰ For this purpose, tentative minimum tax is determined net of alternative minimum tax foreign tax credits and regular tax is determined net of regular tax foreign tax credits.

⁵¹ Determined net of the alternative minimum tax foreign tax credit.

reduce its current liability to \$20. The net effect on its minimum tax credits would be a reduction of \$80⁵², giving it minimum tax credits of \$920 available for the following year.

Effective Date

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

⁵² The determination of minimum tax credits available in the following year would be a multiple step process, involving an increase in the stock of minimum tax credits by the amount that tentative minimum tax exceeds regular tax (\$100), combined with a reduction by the amount used (\$180), for a net reduction of \$80.

VIII. SMALL BUSINESS TAX RELIEF PROVISIONS

A. Accelerate 100-Percent Self-Employed Health Insurance Deduction

Present Law

Under present law, the tax treatment of health insurance expenses depends on the individual's circumstances. Self-employed individuals may deduct a portion of health insurance expenses for the individual and his or her spouse and dependents. The deductible percentage of health insurance expenses of a self-employed individual is 60 percent in 1999 through 2001, 70 percent in 2002, and 100 percent in 2003 and thereafter. The deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse.

Employees can exclude from income 100 percent of employer-provided health insurance.

Individuals who itemize deductions may deduct their health insurance expenses only to the extent that the total medical expenses of the individual exceed 7.5 percent of adjusted gross income (sec. 213). Subject to certain dollar limitations, premiums for qualified long-term care insurance are treated as medical expenses for purposes of the itemized deduction for medical expenses (sec. 213). The amount of qualified long-term care insurance premiums that may be taken into account for 1999 are as follows: \$210 in the case of an individual 40 years old or less; \$400 in the case of an individual who is over 40 but not more than 50; \$800 in the case of an individual who is more than 50 but not more than 60; \$2,120 in the case of an individual who is more than 60 but not more than 70; and \$2,660 in the case of an individual who is more than 70. These dollar limits are indexed for inflation.

The self-employed health deduction also applies to qualified long-term care insurance premiums treated as medical care for purposes of the itemized deduction for medical expenses.

Description of Proposal

Beginning in 2000, the proposal would increase the deduction for health insurance expenses (and qualified long-term care insurance expenses) of self-employed individuals to 100 percent.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

B. Increase Section 179 Expensing

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$19,000 (for taxable years beginning in 1999) of the cost of qualifying property placed in service for the taxable year (sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The \$19,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

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

Description of Proposal

The proposal would provide that the maximum dollar amount that may be deducted under section 179 is increased to \$30,000 for taxable years beginning in 2000 and thereafter, without the present-law phase-in rule.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

C. Repeal of Temporary Federal Unemployment Surtax

Present Law

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

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8-percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax subsequently has been extended through 2007.

Description of Proposal

The proposal would repeal the temporary FUTA surtax after December 31, 2004.

Effective Date

The provision would be effective for labor performed on or after January 1, 2005.

D. Restore 80-Percent Meals Deduction

Present Law

Ordinary and necessary business expenses, as well as expenses incurred for the production of income, are generally deductible, subject to a number of restrictions and limitations. Generally, the amount allowable as a deduction for business meal and entertainment expenses is limited to 50 percent of the otherwise deductible amount. Exceptions to this 50-percent rule are provided for food and beverages provided to crew members of certain vessels and offshore oil or gas platforms or drilling rigs, as well as to individuals subject to the hours of service limitations of the Department of Transportation.

Description of Proposal

The proposal would phase in an increase from 50 percent to 80 percent in the deductible percentage of business meal (food and beverage) expenses. The increase in the deductible percentage is phased in according to the following schedule:

Taxable years beginning in--	Deductible percentage
2005	55
2006	60
2007	65
2008	70
2009	75
2010 and thereafter	80

Effective Date

The proposal would be effective for taxable years beginning after 2004.

IX. INTERNATIONAL TAX RELIEF PROVISIONS

A. Allocate Interest Expense on Worldwide Basis

Present Law

In general

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign- source gross income, on the other. Generally, it is left to the Treasury to provide detailed rules for the allocation and apportionment of expenses.

In the case of interest expense, regulations generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. (Exceptions to the fungibility concept are recognized or required, however, in particular cases, some of which are described below.) The Code provides that for interest allocation purposes all members of an affiliated group of corporations generally are to be treated as a single corporation (the so-called "one-taxpayer rule"), and that allocation must be made on the basis of assets rather than gross income.

Affiliated group

The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns. However, some groups of corporations are eligible to file consolidated returns yet are not treated as affiliated for interest allocation purposes, and other groups of corporations are treated as affiliated for interest allocation purposes even though they are not eligible to file consolidated returns. Thus, under the one-taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another, related corporation even if the two corporations do not elect to file, or are ineligible to file, consolidated returns. (See, e.g., Treas. Reg. sec. 1.861-11T(g).)

Definition of affiliated group--consolidated return rules

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if the common parent owns directly at least 80 percent of the total voting power of all classes of stock and at least 80 percent of the total value of all outstanding stock of at least one other includible corporation. In addition, for each such other includible corporation (except the common parent), stock possessing at least 80 percent of the total voting power of all classes of its stock and at least 80 percent of the total value of all of its outstanding stock must be directly owned by one or more other includible corporations.

Generally the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

Definition of affiliated group--special interest allocation rules

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other. For example, both definitions exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rule does not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group. Moreover, Congress in 1986 expressly considered and rejected a rule that would have accomplished a result more consistent with worldwide fungibility by taking foreign members' indebtedness into account when allocating the interest expense of the domestic members (H. Rept. 99-841, II-605 (1986)). In practice, the limit in the degree of fungibility recognized by present law can reduce the foreign tax credit limitations that otherwise would apply if the principle of fungibility were extended to foreign and domestic members of a commonly controlled group.

The statutory definition of affiliation for purposes of group-wide allocation of interest expenses expressly provides for two exceptions from the definition of affiliation for consolidation purposes, one of which contracts the affiliated group and the other of which expands it.

Banks, savings institutions and other financial affiliates

Under the first-mentioned exception, the affiliated group for interest allocation purposes generally excludes what are referred to in the regulations as "financial corporations" (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies, subsidiaries of banks and bank holding companies, and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other nonfinancial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

Section 936 corporations

Under the second exception referred to above, the affiliated group for interest allocation purposes includes any corporation that has elected the application of the possession tax credit for the taxable year, if the corporation would be excluded solely for this reason from the affiliated group as defined for consolidation purposes (sec. 864(e)(5)(A)).

Description of Proposal

Worldwide affiliated group election

The proposal would modify the present-law interest expense allocation rules under section 864(e) by providing a one-time election under which the taxable income of an affiliated group from sources outside the United States generally would be determined by allocating and apportioning all interest expense of the worldwide affiliated group on a group-wide basis. The election would provide taxpayers with the option either to apply fungibility principles on a worldwide basis or to continue to apply present law. For purposes of the new elective rules based on worldwide fungibility, the affiliated group (as that term is used under present law for interest expense allocation purposes)⁵³ would be expanded to include any foreign corporations in which more than 50 percent of the total combined voting power or the total value of the stock of such corporation is owned (directly or indirectly) by U.S. members of the affiliated group.⁵⁴ A pro rata portion (based on the value of the U.S. members' interest in the foreign corporation) of the foreign corporation's interest expense and assets would be treated as attributable to the affiliated group and taken into account for purposes of determining the allocation and apportionment of interest expense. Thus, subject to certain exceptions described below, the taxable income from sources outside the United States of U.S. electing group members would be determined by allocating and apportioning interest expense as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group under present-law section 864(e)(5)(A)) and a pro rata portion of the interest expense and assets of greater than 50-percent owned foreign subsidiaries were attributable to a single corporation.

The general rules under present law would apply to the electing worldwide affiliated group as if it were an affiliated group as defined under present law for interest expense allocation purposes. Thus, among other things, the allocation and apportionment of interest expense would continue to be made on the basis of assets (rather than gross income), modified in the case of foreign members to include only a pro rata share of the foreign member's assets.

⁵³ A modification would be made to the present-law definition of an affiliated group for expense allocation purposes to include certain insurance companies that are generally excluded from an affiliated group under section 1504(b)(2).

⁵⁴ More specifically, the affiliated group would include all foreign corporations in which U.S. members of the affiliated group satisfy the ownership requirements of section 957 (defining controlled foreign corporations), determined without regard to the constructive ownership rules of section 958(b).

Although a pro rata portion of the interest expense of a foreign subsidiary would be taken into account for purposes of allocating the interest expense of the U.S. members of the group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary would not be deductible on a U.S. return. After calculating the interest expense allocation based on the worldwide affiliated group, the interest expense preliminarily allocable to foreign-source income would be reduced (but not below zero) by the interest expense taken into account in determining the allocation that was incurred by a foreign corporation to the extent that such interest would be allocated to foreign sources if the proposal's principles were applied separately to the foreign members of the group.

Annual elections

Regardless of whether a taxpayer elects to continue to be governed by the present-law allocation rules or to apply the new worldwide fungibility principle, the proposal would provide two annual elections that are exceptions to the "one-taxpayer" rule described above: (1) the "subsidiary group" election, and (2) a "financial institution group" election.

Subsidiary group election

Under the subsidiary group election, at the annual election of the common parent of the affiliated group, certain interest expense attributable to qualified indebtedness incurred by a U.S. member of the affiliated group (other than the common parent) would be allocated and apportioned by treating the borrower and its direct and indirect subsidiaries as a separate group, and by applying the regime that was elected by the entire affiliated group (i.e., present law or the worldwide fungibility principles of the proposal) to that separate group. For this purpose, qualified indebtedness generally means any borrowing from unrelated parties that is not guaranteed or in any other way supported by any corporation within the same affiliated group (other than a member of the subsidiary group) of the borrower. If the common parent makes the election with respect to a U.S. member of an affiliated group, it applies to all direct and indirect subsidiaries of that member. No member of an electing subsidiary group could be treated as a member of another electing subsidiary group. Therefore, a separate subsidiary group election could not be made with respect to lower-tier subsidiaries in an electing subsidiary group. An "equalization" rule also would apply under which interest expense (if any) incurred by members of the affiliated group with respect to indebtedness that is not qualified indebtedness of an electing subsidiary group would be allocated first to foreign-source income to the extent necessary to achieve (if possible) the allocation and apportionment of interest expense to foreign-source income that would have resulted had the subsidiary group election not been made. In addition, certain anti-abuse rules would apply under which certain transfers from one member of a subsidiary group to a member of the affiliated group outside of the subsidiary group would be treated as reducing the amount of qualified indebtedness.

Financial institution group election

The financial institution group election would expand and replace the bank group rules of present law (sec. 864(e)(5)(B)-(D)). At the annual election of the common parent of the affiliated

group, the interest expense allocation and apportionment rules that apply to the affiliated group as a whole (i.e., present law or the worldwide approach), could be applied separately to a subgroup of the affiliated group consisting of corporations that are predominantly engaged in a banking, insurance, financing, or similar business (as well as certain bank holding companies). For this purpose, a corporation would be predominantly engaged in such a business if at least 80 percent of its gross income is "financial services income" (as described in section 904(d)(2)(C)(ii) and the regulations thereunder). The financial institution group rules, if elected, would apply to all members of the affiliated group that are considered to be predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, or otherwise considered to be a bank holding company. In addition, if a financial institution group election has been made, a member of the affiliated group that is part of the financial institution group could not also be a member of a separate subsidiary group at the same time. Anti-abuse rules (similar to those that would apply in connection with the subsidiary group election) also would apply.

Regulatory authority

The Treasury Secretary would be granted authority to prescribe rules to carry out the purposes of the proposal, including rules (1) to address changes in members of an affiliated group (including acquisitions or other business combinations of affiliated groups in which one group has made an election to apply the worldwide approach and the other group applies current law); (2) to prevent assets and interest expense from being taken into account more than once; and (3) to provide for direct allocation of interest expense in circumstances where such allocation would be appropriate to carry out the purposes of the proposal.

Effective Date

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

B. Look-Through Rules to Apply to Dividends from Noncontrolled Section 902 Corporations

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that may be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called “10/50 company”).⁵⁵ Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003, are subject to a separate foreign tax credit limitation for each 10/50 company. Dividends paid by a 10/50 company that is not a passive foreign investment company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years beginning before January 1, 2003, are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies). Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years after December 31, 2002, are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a so-called “look-through” approach). For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Description of Proposal

The proposal would simplify the application of the foreign tax credit limitation by applying the look-through approach to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.

The proposal would provide a transition rule under which pre-effective date foreign tax credits associated with a 10/50 company separate limitation category can be carried forward into post-effective date years. Under the proposal, look-through principles similar to those applicable to post-effective date dividends from a 10/50 company would apply to determine the appropriate

⁵⁵ A controlled foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote is treated as a 10/50 company with respect to any distribution out of earnings and profits for periods when it was not a controlled foreign corporation.

foreign tax credit limitation category or categories with respect to the foreign tax credit carryforward.

The proposal also would provide a default rule in cases in which taxpayers are unable to obtain the necessary information to apply the look-through rules with respect to dividends from a 10/50 company. In such cases, the proposal would treat the dividend (or a portion thereof) from such 10/50 company as a dividend that would not be subject to the look-through rules.

Effective Date

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

C. Subpart F Treatment of Pipeline Transportation Income and Income from Transmission of High Voltage Electricity

Present Law

Under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation (“CFC”) are subject to U.S. tax currently on their shares of certain income earned by the foreign corporation, whether or not such income is distributed to the shareholders (referred to as “subpart F income”). Subpart F income includes foreign base company income, which in turn includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income (sec. 954(a)).

Foreign base company services income includes income from services performed (1) for or on behalf of a related party and (2) outside the country of the CFC’s incorporation (sec. 954(e)). Treasury regulations provide that the services of the foreign corporation will be treated as performed for or on behalf of the related party if, for example, a party related to the foreign corporation furnishes substantial assistance to the foreign corporation in connection with the provision of services (Treas. Reg. sec. 1.954-4(b)(1)(iv)).

Foreign base company oil related income is income derived outside the United States from the processing of minerals extracted from oil or gas wells into their primary products; the transportation, distribution, or sale of such minerals or primary products; the disposition of assets used by the taxpayer in a trade or business involving the foregoing; or the performance of any related services. However, foreign base company oil related income does not include income derived from a source within a foreign country in connection with: (1) oil or gas which was extracted from a well located in such foreign country or, (2), oil, gas, or a primary product of oil or gas which is sold by the CFC or a related person for use or consumption within such foreign country or is loaded in such country as fuel on a vessel or aircraft. An exclusion also is provided for income of a CFC that is a small producer (i.e., a corporation whose average daily oil and natural gas production, including production by related corporations, is less than 1,000 barrels).

Description of Proposal

The proposal would exempt income derived in connection with the performance of services which are directly related to the transmission of high voltage electricity from the definition of foreign base company services income. Thus, the income of a CFC that owns a high voltage transmission line for the purpose of providing electricity generated by a related party to a third party outside the CFC's country of incorporation would not constitute foreign base company services income. No inference would be intended as to the treatment of such income under present law.

The proposal also would provide an additional exception to the definition of foreign base company oil related income. Under the proposal, foreign base company oil related income would

not include income derived from a source within a foreign country in connection with the pipeline transportation of oil or gas within such foreign country. Thus, the proposed exception would apply whether or not the CFC that owns the pipeline also owns any interest in the oil or gas transported. In addition, the proposed exception would apply to income earned from the transportation of oil or gas by pipeline in a country in which the oil or gas was neither extracted nor consumed within such foreign country.

Effective Date

The proposal would be effective for taxable years of CFCs beginning after December 31, 2001, and taxable years of U.S. shareholders with or within which such taxable years of CFCs end.

D. Recharacterization of Overall Domestic Loss

Present Law

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S.-source income; rather, it should only reduce U.S. tax on foreign-source income. An overall foreign tax credit limitation prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. The overall limitation is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide income between its U.S.-source and foreign-source taxable income. The ratio (not exceeding 100 percent) of the taxpayer's foreign-source taxable income to worldwide taxable income is multiplied by its pre-credit U.S. tax to establish the amount of U.S. tax allocable to the taxpayer's foreign-source income and, thus, the upper limit on the foreign tax credit for the year. If the taxpayer's foreign-source taxable income exceeds worldwide taxable income (because of a domestic source loss), then the full amount of pre-credit U.S. tax may be offset by the foreign tax credit.

If a taxpayer's losses from foreign sources exceed its foreign-source income, the excess ("overall foreign loss" or "OFL") may offset U.S.-source income. Such an offset reduces the effective rate of U.S. tax on U.S.-source income. To eliminate a double benefit (that is, the reduction of U.S. tax previously noted and, later, full allowance of a foreign tax credit with respect to foreign-source income), an OFL recapture rule applies. Under this rule, a portion of foreign-source taxable income earned after an OFL year is recharacterized as U.S.-source taxable income for foreign tax credit purposes (and for purposes of the possessions tax credit) (sec. 904(f)(1)). Foreign-source taxable income up to the amount of the unrecaptured OFL may be so treated. In general, no more than 50 percent of the foreign-source taxable income earned in any particular taxable year is recharacterized as U.S.-source taxable income, unless a taxpayer elects a higher percentage.⁵⁶ The effect of the recapture is to reduce the foreign tax credit limitation in one or more years following an OFL year and, therefore, the amount of U.S. tax that can be offset by foreign tax credits in the later year or years.

An overall U.S.-source loss reduces pre-credit U.S. tax on worldwide income to an amount less than the hypothetical tax that would apply to the taxpayer's foreign-source income if viewed in isolation. The existence of foreign-source taxable income in the year of the U.S. loss reduces or eliminates any net operating loss carryover that the U.S. loss would otherwise have generated absent the foreign income. In addition, as the pre-credit U.S. tax on worldwide income is reduced, so is the foreign tax credit limitation. As a result, some foreign tax credits in the year of the U.S.

⁵⁶ If a taxpayer with an OFL disposes of property that was used predominantly outside the United States in a trade or business, the taxpayer generally is deemed to have received and recognized foreign-source taxable income as the result of a disposition in an amount at least equal to the lesser of the gain actually realized on the disposition or the remaining amount of the unrecaptured OFL. Furthermore, the annual 50-percent limit on the resourcing of foreign-source income does not apply to that amount of foreign-source income realized by reason of the disposition.

loss must be credited, if at all, in a carryover year. Tax on domestic-source taxable income in a subsequent year may be offset by a net operating loss carryforward (if any), but not by a foreign tax credit carryforward. There is presently no mechanism for resourcing such subsequent U.S.-source income as foreign-source income.

Description of Proposal

The proposal would apply a resourcing rule to U.S.-source income where the taxpayer has suffered a reduction in the amount of its foreign tax credit limitation due to a prior overall domestic loss. Under the proposal, in the case of a taxpayer that has incurred an overall domestic loss, the portion of the taxpayer's U.S.-source taxable income for each succeeding taxable year that is equal to the lesser of (1) the amount of the unrecharacterized overall domestic loss, or (2) 50 percent of the taxpayer's U.S.-source taxable income for such succeeding taxable year would be recharacterized as foreign-source taxable income.

The proposal would define an overall domestic loss for this purpose as any domestic loss to the extent it offsets foreign-source taxable income for the current taxable year or for any preceding taxable year by reason of a loss carryback. For this purpose, a domestic loss means the amount by which the U.S.-source gross income for the taxable year is exceeded by the sum of the deductions properly apportioned or allocated thereto, determined without regard to any loss carried back from a subsequent taxable year. Under the proposal, an overall domestic loss would not include any loss for any taxable year unless the taxpayer elected the use of the foreign tax credit for such taxable year.

Any U.S.-source income resourced under the proposal would be allocated among the various foreign tax credit separate limitation categories in the same proportion that those categories were reduced by the prior overall domestic loss.

It is anticipated that situations could arise in which a taxpayer would generate an overall domestic loss in a year following a year in which it had an overall foreign loss, or vice versa. In such a case, it would be necessary for ordering and other coordination rules to be developed for purposes of computing the foreign tax credit limitation in subsequent taxable years. The proposal would grant the Treasury Secretary authority to prescribe such regulations as may be necessary to coordinate the operation of the OFL recapture rules with the operation of the overall domestic loss recharacterization rules that would be added by the proposal.

Effective Date

The proposal would apply to losses incurred in taxable years beginning after December 31, 2004.

E. Treatment of Military Property of Foreign Sales Corporations

Present Law

A portion of the foreign trade income of an eligible foreign sales corporation (“FSC”) is exempt from federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable to foreign trading gross receipts. In general, the term “foreign trading gross receipts” means the gross receipts of a FSC from the sale or lease of export property, services related and subsidiary to the sale or lease of export property, engineering or architectural services for construction projects located outside the United States, and certain managerial services for an unrelated FSC or DISC.

Section 923(a)(5) contains a special limitation relating to the export of military property. Under regulations prescribed by the Treasury Secretary, the portion of a FSC's foreign trading gross receipts from the disposition of, or services relating to, military property that may be treated as exempt foreign trade income is limited to 50 percent of the amount that would otherwise be so treated. For this purpose, the term “military property” means any property that is an arm, ammunition, or implement of war designated in the munitions list published pursuant to federal law.⁵⁷ Under this provision, the export of military property through a FSC is accorded one-half the tax benefit that is accorded to exports of non-military property.

Description of Proposal

The proposal would repeal the special FSC limitation relating to the export of military property, thus providing exports of military property through a FSC with the same treatment currently provided exports of non-military property.

Effective Date

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

⁵⁷ Section 923(a)(5) defines “military property” by reference to section 995(b)(3)(B), which contains a technical error. Section 995(b)(3)(B) references the Military Security Act of 1954. The proper reference should have been to the Mutual Security Act of 1954, which subsequently was superseded by the International Security Assistance and Arms Export Control Act of 1976. Current Treasury regulations provide the correct reference for purposes of defining “military property.”

F. Modify Treatment of RIC Dividends Paid to Foreign Persons

Present Law

Regulated investment companies

A regulated investment company ("RIC") is a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)).

In addition, to qualify as a RIC, a corporation must elect such status and must satisfy certain tests (sec. 851(b)). These tests include a requirement that the corporation derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains on the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investment in such stock, securities, or currencies.

Generally, a RIC pays no income tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. The amount of any distribution generally is not considered as a dividend for purposes of computing the dividends paid deduction unless the distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class (sec. 562(c)). For distributions by RICs to shareholders who made initial investments of at least \$10,000,000, however, the distribution is not treated as non-pro rata or preferential solely by reason of an increase in the distribution due to reductions in administrative expenses of the company.

A RIC generally may pass through to its shareholders the character of its long-term capital gains. It does this by designating a dividend it pays as a capital gain dividend to the extent that the RIC has net capital gain (i.e., net long-term capital gain over net short-term capital loss). These capital gain dividends are treated as long-term capital gains by the shareholders. A RIC generally also can pass through to its shareholders the character of tax-exempt interest from State and municipal bonds, but only if, at the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consists of these obligations. In this case, the RIC generally may designate a dividend it pays as an exempt-interest dividend to the extent that the RIC has tax-exempt interest income. These exempt-interest dividends are treated as interest excludable from gross income by the shareholders.

U.S. source investment income of foreign persons

In general

The United States generally imposes a flat 30-percent tax, collected by withholding, on the gross amount of U.S.-source investment income payments, such as interest, dividends, rents, royalties, or similar types of income, to nonresident alien individuals and foreign corporations

("foreign persons") (secs. 871(a), 881, 1441, and 1442). Under treaties, the United States may reduce or eliminate such taxes. Even taking into account U.S. treaties, however, the tax on a dividend generally is not entirely eliminated. Instead, U.S.-source portfolio investment dividends received by foreign persons generally are subject to U.S. withholding tax at a rate of at least 15 percent.

Interest

Although payments of U.S.-source interest that is not effectively connected with a U.S. trade or business generally are subject to the 30-percent withholding tax, there are significant exceptions to that rule. For example, interest from certain deposits with banks and other financial institutions is exempt from tax (secs. 871(i)(2)(A) and 881(d)). Original issue discount on obligations maturing in 183 days or less from the date of original issue (without regard to the period held by the taxpayer) is also exempt from tax (sec. 871(g)). An additional exception is provided for certain interest paid on portfolio obligations (secs. 871(h) and 881(c)). "Portfolio interest" generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto (i.e., the obligation is "foreign targeted"), and (2) that is not received by a 10-percent shareholder (secs. 871(h)(3) and 881(c)(3)). With respect to a registered obligation, a statement that the beneficial owner is not a U.S. person is required (secs. 871(h)(2), (5) and 881(c)(2)). This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person (sec. 881(c)(3)). Moreover, this exception is not available for certain contingent interest payments (secs. 871(h)(4) and 881(c)(4)). The payment of interest must not be to any person within a foreign country (and must not be a payment addressed to, or for the account of, persons within a foreign country) with respect to which the Treasury Secretary has determined that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons (secs. 871(h)(6), and 881(c)(6)).

Capital gains

Foreign persons generally are not subject to U.S. tax on gain realized on the disposition of stock or securities issued by a U.S. person (other than a "U.S. real property holding corporation," as described below), unless the gain is effectively connected with the conduct of a trade or business in the United States. This exemption does not apply, however, to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year (sec. 871(a)(2)). A RIC may elect not to withhold on a distribution to a foreign person representing a capital gain dividend. (Treas. Reg. sec. 1.1441-3(c)(2)(D)).

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), as amended, gain or loss of a foreign person from the disposition of a U.S. real property interest is subject to net basis tax as if the taxpayer were engaged in a trade or business within the United States and the gain or loss were effectively connected with such trade or business (sec. 897). In addition to an interest

in real property located in the United States or the Virgin Islands, U.S. real property interests include (among other things) any interest in a domestic corporation unless the taxpayer establishes that the corporation was not, during a 5-year period ending on the date of the disposition of the interest, a U.S. real property holding corporation (which is defined generally to mean a corporation the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of its real property interests and any other of its assets used or held for use in a trade or business).

Under the FIRPTA provisions, a distribution by a real estate investment trust ("REIT") to a foreign person is, to the extent attributable to gain from sales or exchanges by the REIT of U.S. real property interests, treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest (sec. 897(h)). Under Treasury regulations, a REIT generally is required to withhold tax upon such a distribution to a foreign person, at a rate of 35 percent times the maximum amount of that distribution that could be designated by the REIT as a capital gain dividend (Treas. Reg. sec. 1.1445-8(a)(2), (b)(1), and (c)(2)).

In view of the nature of a REIT, an interest in a REIT may in some cases be considered to be a U.S. real property interest. An interest in a domestically-controlled REIT, however, is not considered a U.S. real property interest (sec. 897(h)(2)). Nonetheless, the foreign ownership percentage of taxable appreciation in the value of a U.S. real property interest distributed by a domestically-controlled REIT is subject to tax in the hands of the REIT (sec. 897(h)(3)).

Estate taxation

Decedents who were citizens or residents of the United States are generally subject to Federal estate tax on all property, wherever situated. Nonresidents who are not U.S. citizens, however, are subject to estate tax only on their property which is within the United States. Property within the United States generally includes debt obligations of U.S. persons, including the Federal government and State and local governments (sec. 2104(c)), but does not include either bank deposits or portfolio obligations, the interest on which would be exempt from U.S. income tax under section 871 (sec. 2105(b)). Stock owned and held by a nonresident who is not a U.S. citizen is treated as property within the United States only if the stock was issued by a domestic corporation (sec. 2104(a); Treas. Reg. sec. 20.2104-1(a)(5)).

Treaties may reduce U.S. taxation on transfers by estates of nonresident decedents who are not U.S. citizens. Under recent treaties, for example, U.S. tax may generally be eliminated except insofar as the property transferred includes U.S. real property or business property of a U.S. permanent establishment.

Description of Proposal

In general

Under the proposal, a RIC that earns certain interest income which would not be subject to

U.S. tax if earned by a foreign person directly may, to the extent of such income, designate a dividend it pays as derived from such interest income. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had earned the interest directly. Similarly, a RIC that earns an excess of net short-term capital gains over net long-term capital losses, which excess would not be subject to U.S. tax if earned by a foreign person directly, generally may, to the extent of such excess, designate a dividend it pays as derived from such excess. A foreign person who is a shareholder in the RIC generally would treat such a dividend as exempt from gross-basis U.S. tax, just as if the foreign person had realized the amount directly. The estate of a foreign decedent would be exempt from U.S. estate tax on a transfer of stock in the RIC in the proportion that the assets held by the RIC are debt obligations, deposits, or other property that would generally be treated as situated outside the United States if held directly by the estate.

Interest-related dividends

Under the proposal, a RIC could, under certain circumstances, designate all or a portion of a dividend as an "interest-related dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. An interest-related dividend received by a foreign person generally would be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442.

This exemption would not apply, however, to a dividend on shares of RIC stock in a case where the withholding agent does not receive a statement, similar to that required under the portfolio interest rules, that the beneficial owner of the shares is not a U.S. person. The exemption would not apply to a dividend paid to any person within a foreign country (or dividends addressed to, or for the account of, persons within such foreign country) with respect to which the Treasury Secretary has determined, under the portfolio interest rules, that exchange of information is inadequate to prevent evasion of U.S. income tax by U.S. persons.

In addition, the exemption generally would not apply to dividends paid to a controlled foreign corporation to the extent such dividends are attributable to income received by the RIC on a debt obligation of a person with respect to which the recipient of the dividend (i.e., the controlled foreign corporation) is a related person. Nor would the exemption generally apply to dividends to the extent such dividends are attributable to income (other than short-term original discount or bank deposit interest) received by the RIC on indebtedness issued by the RIC- dividend recipient or by any corporation or partnership with respect to which the recipient of the RIC dividend is a 10-percent shareholder. In these two cases, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient is such a controlled foreign corporation or 10-percent shareholder. To the extent that an interest-related dividend received by a controlled foreign corporation is attributable to interest income of the RIC that would be portfolio interest if received by a foreign corporation, the dividend would be treated as portfolio interest for purposes of the de minimis rules, the high-tax exception, and the same country exceptions of subpart F (see sec. 881(c)(5)(A)).

The aggregate amount designated as interest-related dividends for the RIC's taxable year

(including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in section 855) generally is limited to the qualified net interest income of the RIC for the taxable year. The qualified net interest income of the RIC equals the excess of (1) the amount of qualified interest income of the RIC over (2) the amount of direct and indirect expenses of the RIC properly allocable to such interest income.

Qualified interest income of the RIC is the sum of (1) its U.S.-source income with respect to (a) bank deposit interest; (b) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (c) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (d) any interest-related dividend from another RIC; and (2) its foreign-source interest unless such interest is subject to a tax imposed by a foreign jurisdiction that is reduced or eliminated by a treaty with the United States.

Where the amount designated as an interest-related dividend is greater than the qualified net interest income described above, then the portion of the distribution so designated which constitutes an interest-related dividend will be only that proportion of the amount so designated as the amount of the qualified net interest income bears to the amount so designated.

Short-term capital gain dividends

Under the proposal, a RIC could also, under certain circumstances, designate all or a portion of a dividend as a "short-term capital gain dividend," by written notice mailed to its shareholders not later than 60 days after the close of its taxable year. For purposes of the U.S. gross-basis tax, a short-term capital gain dividend received by a foreign person generally would be exempt from U.S. gross-basis tax under sections 871(a), 881, 1441 and 1442. This exemption would not apply to the extent that the foreign person is a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year. In this case, however, the RIC remains exempt from its withholding obligation unless the RIC knows that the dividend recipient has been present in the United States for such period.

The aggregate amount qualified to be designated as short-term capital gain dividends for the RIC's taxable year (including dividends so designated that are paid after the close of the taxable year but treated as paid during that year as described in sec. 855) is the excess of the RIC's net short-term capital gains over net long-term capital losses. The net short-term capital gains would include short-term capital gain dividends from another RIC. As is provided under present law for purposes of computing the amount of a capital gain dividend, the amount is determined (except in the case where an election under sec. 4982(e)(4) applies) without regard to any net capital loss or net short-term capital loss attributable to transactions after October 31 of the year. Instead, that loss would be treated as arising on the first day of the next taxable year. To the extent provided in regulations, this rule also would apply for purposes of computing the taxable income of the RIC.

In computing the amount of short-term capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC allocable to such net gains. In addition, where the amount designated as short-term capital gain dividends is greater than the amount of qualified short-term capital gain, then the portion of the distribution so designated which constitutes a short-term capital gain dividend will be only that proportion of the amount so designated as the amount of the excess bears to the amount so designated.

As is true under present law for distributions from REITs, the proposal would provide that any distribution by a RIC to a foreign person shall, to the extent attributable to gain from the sale or exchange by the RIC of an asset that is considered a U.S. real property interest, be treated as gain recognized by the foreign person from the sale or exchange of a U.S. real property interest. The proposal also would extend the special rules applicable to domestically-controlled REITs to domestically-controlled RICs.

Estate tax treatment

Under the proposal, a portion of the stock in a RIC held by the estate of a nonresident decedent who is not a U.S. citizen would be treated as property without the United States. The portion so treated would be based on the proportion of the assets held by the RIC at the end of the quarter immediately preceding the decedent's death (or such other time as the Secretary may designate in regulations) that are "qualifying assets." Qualifying assets for this purpose are bank deposits of the type that are exempt from gross-basis income tax, portfolio debt obligations, certain original issue discount obligations, debt obligations of a domestic corporation that are treated as giving rise to foreign source income, and other property not within the United States.

Effective Date

The proposal generally would apply to dividends with respect to taxable years of RICs beginning after December 31, 2004. With respect to the treatment of a RIC for estate tax purposes, the proposal would apply to estates of decedents dying after December 31, 2004. With respect to the treatment of RICs under section 897 (dealing with U.S. real property interests), the proposal would be effective on January 1, 2005.

G. Repeal of Special Rules for Applying Foreign Tax Credit in Case of Foreign Oil and Gas Income

Present Law

U.S. persons are subject to U.S. income tax on their worldwide income. A credit against U.S. tax on foreign-source income is allowed for foreign taxes paid or accrued (or deemed paid) (secs. 901, 902).

The amount of foreign tax credits that a taxpayer may claim in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income (sec. 904). The foreign tax credit limitation is calculated on an overall basis and separately for specific categories of income. The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year that exceeds the respective foreign tax credit limitations is permitted to be carried back two years and carried forward five years (sec. 904(c)).

Special rules apply with respect to the foreign tax credit in the case of foreign oil and gas income (sec. 907). Under a special limitation, taxes on foreign oil and gas extraction income are creditable only to the extent that they do not exceed a specified amount (e.g., 35 percent of such income in the case of a corporation) (sec. 907(a)). For this purpose, foreign oil and gas extraction income is income derived from foreign sources from the extraction of minerals from oil or gas wells or the sale or exchange of assets used by the taxpayer in such extraction. A taxpayer must have excess limitation under the special rules applicable to foreign extraction taxes and excess limitation under the general foreign tax credit provisions in order to utilize excess foreign oil and gas extraction taxes in a carryback or carryforward year. A recapture rule applicable to foreign oil and gas extraction losses treats income that otherwise would be foreign oil and gas extraction income as foreign-source income that is not considered oil and gas extraction income; the taxes on such income retain their character as foreign oil and gas extraction taxes and continue to be subject to the special limitation imposed on such taxes.

In the case of taxes paid or accrued to any foreign country with respect to foreign oil related income, discriminatory foreign taxes are not treated as creditable foreign taxes (sec. 907(b)). Foreign taxes are discriminatory for this purpose to the extent that the Treasury Secretary determines that the foreign law imposing the tax is structured, or in facts operates, so that the amount of tax imposed with respect to foreign oil related income will be materially greater, over a reasonable period of time, than the amount imposed on non-oil related and non-extraction income. Foreign oil related income is income derived from foreign sources from the processing of minerals extracted from oil or gas wells into their primary products; the transportation, distribution, or sale of such minerals or primary products; the disposition of assets used by the taxpayer in one of the foregoing businesses; or the performance of any related service. To the extent that such taxes are treated as not creditable, the amount is treated as a deduction under foreign law (i.e., the amount is treated as a deductible business expense for purposes of computing an appropriate level of foreign income tax and for U.S. tax purposes).

Description of Proposal

The proposal would repeal the special rules of section 907 for applying the foreign tax credit in the case of foreign oil and gas income. Thus, taxes attributable to foreign oil and gas extraction income would no longer be subject to a special limitation, but rather would be subject to the general limitation rules of section 904. Additionally, the special rules of section 907 with respect to discriminatory taxes on foreign oil related income would no longer apply.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2004.

H. Study of Proper Treatment of European Union under Subpart F Same Country Exceptions

Present Law

In general, U.S. 10-percent shareholders of a controlled foreign corporation (“CFC”) are required to include in income for U.S. tax purposes currently certain income of the CFC (referred to as “subpart F income”), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a CFC as having received a current distribution of their pro rata shares of the CFC's subpart F income. For this purpose, a U.S. 10-percent shareholder is a U.S. person that owns 10 percent or more of the corporation's stock (measured by vote) (sec. 951(b)). In general, a foreign corporation is a CFC if U.S. 10-percent shareholders own more than 50 percent of such corporation's stock (measured by vote or by value) (sec. 957).

Subpart F income typically is passive income or income that is relatively movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)-(5)). Subpart F income does not include income of the CFC that is effectively connected with the conduct of a trade or business within the United States (on which income the CFC is subject to current U.S. tax) (sec. 952(b)).

Income of a CFC may be excepted from the subpart F provisions under various same country exceptions. For example, a major category of foreign base company income is foreign personal holding company income, which generally includes, among other things, certain dividends, interest, rents and royalties (sec. 954(c)). Same country exceptions from treatment as foreign personal holding company income generally are provided for dividends and interest received by the CFC from a related person that (1) is a corporation organized under the laws of the same foreign country in which the CFC is created or organized and (2) has a substantial part of its assets used in a trade or business located in such same foreign country. Similarly, same country exceptions from foreign personal holding income generally are provided for rents and royalties received by the CFC from a related corporation for the use of property within the country in which the CFC is created or organized (sec. 954(c)(3)).

Description of Proposal

The proposal would direct the Treasury Secretary to conduct a study of the feasibility of treating all countries included in the European Union as one country for purposes of applying same country exceptions under subpart F. The proposal would require the results of the study to be reported to the House Committee on Ways and Means and the Senate Committee on Finance, along with any legislative recommendations, no later than 6 months after the date of enactment.

I. Provide Waiver from Denial of Foreign Tax Credits

Present Law

In general, U.S. persons may credit foreign taxes against U.S. tax on foreign-source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S.-source income. Separate limitations are applied to specific categories of income.

Pursuant to special rules applicable to taxes paid to certain foreign countries, no foreign tax credit is allowed for income, war profits, or excess profits taxed paid, accrued, or deemed paid to a country which satisfies specified criteria, to the extent that the taxes are with respect to income attributable to a period during which such criteria were satisfied (sec. 901(j)). Section 901(j) applies with respect to any foreign country: (1) the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act, (2) with respect to which the United States has severed diplomatic relations, (3) with respect to which the United States has not severed diplomatic relations but does not conduct such relations, or (4) which the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country which repeatedly provides support for acts of international terrorism (a “section 901(j) foreign country”). The denial of credits applies to any foreign country during the period beginning on the later of January 1, 1987, or six months after such country becomes a section 901(j) country, and ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer a section 901(j) country.

Taxes treated as noncreditable under section 901(j) generally are permitted to be deducted notwithstanding the fact that the taxpayer elects use of the foreign tax credit for the taxable year with respect to other taxes. In addition, income for which foreign tax credits are denied generally cannot be sheltered from U.S. tax by other creditable foreign taxes.

Under the rules of subpart F, U.S. 10-percent shareholders of a controlled foreign corporation (“CFC”) are required to include in income currently certain types of income of the CFC, whether or not such income is actually distributed currently to the shareholders (referred to as “subpart F income”). Subpart F income includes income derived from any foreign country during a period in which the taxes imposed by that country are denied eligibility for the foreign tax credit under section 901(j) (sec. 952(a)(5)).

Description of Proposal

The proposal would provide that section 901(j) would no longer apply with respect to a foreign country if the President determines that the application of section 901(j) to such foreign country is not in the national interests of the United States.

Effective Date

The proposal would be effective as of the date of enactment.

J. Prohibit Disclosure of APAs and APA Background Files

Present Law

Section 6103

Under section 6103, returns and return information are confidential and cannot be disclosed unless authorized by the Internal Revenue Code.

Return information is defined broadly. Return information includes:

- C a taxpayer's identity, the nature, source or amount of income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments;
- C whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing; or
- C any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under Title 26 for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense.⁵⁸

Section 6110 and the Freedom of Information Act

With certain exceptions, section 6110 makes the text of any written determination the IRS issues available for public inspection. A written determination is any ruling, technical advice memorandum, or Chief Counsel advice. Once the IRS makes the written determination publicly available, the background file documents associated with such written determination are available for public inspection upon written request. The Code defines “background file documents” as any written material submitted in support of the request. Background file documents also include any communications between the IRS and persons outside the IRS concerning such written determination that occur before the IRS issues the determination.

Before making them available for public inspection, section 6110 requires the IRS to delete specific categories of sensitive information from the written determination and background file documents.⁵⁹ It also provides judicial and administrative procedures to resolve disputes over the scope of the information the IRS will disclose. In addition, Congress has also wholly exempted

⁵⁸ Sec. 6103(b)(2)(A).

⁵⁹ Sec. 6110(c) provides for the deletion of identifying information, trade secrets, confidential commercial and financial information and other material.

certain matters from section 6110's public disclosure requirements.⁶⁰ Any part of a written determination or background file that is not disclosed under section 6110 constitutes "return information."⁶¹

The Freedom of Information Act ("FOIA") lists categories of information that an agency must make available for public inspection.⁶² It establishes a presumption that records in the possession of agencies and departments of the executive branch of the U.S. Government are accessible to the public. The FOIA, however, also provides nine exemptions from public disclosure. One of those exemptions is for matters specifically exempted from disclosure by a statute other than the FOIA if the exempting statute meets certain requirements.⁶³ Section 6103 qualifies as an exempting statute under this FOIA provision. Thus, returns and return information that section 6103 deems confidential are exempt from disclosure under the FOIA.

⁶⁰ Sec. 6110(1).

⁶¹ Sec. 6103(b)(2)(B) ("The term 'return information' means . . . any part of any written determination or any background file document relating to such written determination (as such terms are defined in section 6110(b)) which is not open to public inspection under section 6110").

⁶² Unless published promptly and offered for sale, an agency must provide for public inspection and copying: (1) final opinions as well as orders made in the adjudication of cases; (2) statements of policy and interpretations not published in the Federal Register; (3) administrative staff manuals and instructions to staff that affect a member of the public; and (4) agency records which have been or the agency expects to be, the subject of repetitive FOIA requests. 5 U.S.C. sec. 552(a)(2). An agency must also publish in the Federal Register: the organizational structure of the agency and procedures for obtaining information under the FOIA; statements describing the functions of the agency and all formal and informal procedures; rules of procedure, descriptions of forms and statements describing all papers, reports and examinations; rules of general applicability and statements of general policy; and amendments, revisions and repeals of the foregoing. 5 U.S.C. sec. 552(a)(1). All other agency records can be sought by FOIA request; however, some records may be exempt from disclosure.

⁶³ Exemption 3 of the FOIA provides that an agency is not required to disclose matters that are:

(3) specifically exempted from disclosure by statute (other than section 552b of this title) provided that such statute (A) requires that the matters be withheld from the public in such a manner as to leave no discretion on the issue, or (B) establishes particular criteria for withholding or refers to particular types of matters to be withheld; . . .

5 U.S.C. § 552(b)(3).

Section 6110 is the exclusive means for the public to view IRS written determinations.⁶⁴ If section 6110 covers the written determination, the public cannot use the FOIA to obtain that determination.

Advance Pricing Agreements

The Advanced Pricing Agreement (“APA”) program is an alternative dispute resolution program conducted by the IRS, which resolves international transfer pricing issues prior to the filing of the corporate tax return. Specifically, an APA is an advance agreement establishing an approved transfer pricing methodology entered into among the taxpayer, the IRS, and a foreign tax authority. The IRS and the foreign tax authority generally agree to accept the results of such approved methodology. Alternatively, an APA also may be negotiated between just the taxpayer and the IRS; such an APA establishes an approved transfer pricing methodology for U.S. tax purposes. The APA program focuses on identifying the appropriate transfer pricing methodology; it does not determine a taxpayer’s tax liability. Taxpayers voluntarily participate in the program.

To resolve the transfer pricing issues, the taxpayer submits detailed and confidential financial information, business plans and projections to the IRS for consideration. Resolution involves an extensive analysis of the taxpayer’s functions and risks. Since its inception in 1991, the APA program has resolved more than 180 APAs, and approximately 195 APA requests are pending.

Currently pending in the U.S. District Court for the District of Columbia are three consolidated lawsuits asserting that APAs are subject to public disclosure under either section 6110 or the FOIA.⁶⁵ Prior to this litigation and since the inception of the APA program, the IRS held the position that APAs were confidential return information protected from disclosure by section 6103.⁶⁶ On January 11, 1999, the IRS conceded that APAs are “rulings” and therefore are “written determinations” for purposes of section 6110.⁶⁷ Although the court has not yet issued a

⁶⁴ Sec. 6110(m).

⁶⁵ BNA v. IRS, Nos. 96-376, 96-2820, and 96-1473 (D.D.C.). The Bureau of National Affairs, Inc. (BNA) publishes matters of interest for use by its subscribers. BNA contends that APAs are not return information as they are prospective in application. Thus at the time they are entered into they do not relate to “the determination of the existence, or possible existence, of liability or amount thereof . . .”

⁶⁶ The IRS contended that information received or generated as part of the APA process pertains to a taxpayer’s liability and therefore was return information as defined in sec. 6103(b)(2)(A). Thus, the information was subject to section 6103's restrictions on the dissemination of returns and return information. Rev. Proc. 91-22, sec. 11, 1991-1 C.B. 526, 534 and Rev. Proc. 96-53, sec. 12, 1996-2 C.B. 375, 386.

⁶⁷ IR 1999-05.

ruling in the case, the IRS announced its plan to publicly release both existing and future APAs. The IRS then transmitted existing APAs to the respective taxpayers with proposed deletions. It has received comments from some of the affected taxpayers. Where appropriate, foreign tax authorities have also received copies of the relevant APAs for comment on the proposed deletions. No APAs have yet been released to the public.

Some taxpayers assert that the IRS erred in adopting the position that APAs are subject to section 6110 public disclosure. Several have sought to participate as *amici* in the lawsuit to block the release of APAs. They are concerned that release under section 6110 could expose them to expensive litigation to defend the deletion of the confidential information from their APAs. They are also concerned that the section 6110 procedures are insufficient to protect the confidentiality of their trade secrets and other financial and commercial information.

Description of Proposal

The proposal would provide that APAs and related background information are confidential return information and are not written determinations as that term is defined in section 6110.

The proposal would also statutorily require an annual report by the Treasury Department on APAs. The annual report would contain the following information:

- Ⓒ Information about the structure, composition, and operation of the APA program office;
- Ⓒ A copy of each current model APA;
- Ⓒ Statistics regarding the amount of time to complete new and renewal APAs;
- Ⓒ The number of APA applications filed during such year;
- Ⓒ The number of APAs executed cumulatively to date and for the year;
- Ⓒ The number of APA renewals issued for the year;
- Ⓒ The number of pending APA requests;
- Ⓒ The number of pending APA renewals;
- Ⓒ The number of APAs executed and pending (including renewals and renewal requests) that are unilateral, bilateral and multilateral, respectively;
- Ⓒ The number of APAs revoked or canceled, and the number of withdrawals from the APA program for the year;
- Ⓒ The number of finalized new APAs and renewals by industry;⁶⁸ and

General descriptions of:

- Ⓒ the nature of the relationships between the related organizations, trades, or businesses covered by APAs;
- Ⓒ the related organizations, trades, or businesses whose prices or results are tested

⁶⁸ This information was previously released in IRS Publication 3218, "IRS Report on Application and Administration of I.R.C. Section 482."

- to determine compliance with the transfer pricing methodology prescribed in the advanced pricing agreement;
- C the covered transactions and the functions performed and risks assumed by the related organizations, trades or businesses involved;
 - C methodologies used to evaluate tested parties and transactions and the circumstances leading to the use of those methodologies;
 - C critical assumptions;
 - C sources of comparables;
 - C comparable selection criteria and the rationale used in determining such criteria;
 - C the nature of adjustments to comparables or tested parties;
 - C the nature of any range agreed to, including information such as whether no range was used and why, whether an inter-quartile range was used, or whether there was a statistical narrowing of the comparables;
 - C adjustment mechanisms provided to rectify results that fall outside of the agreed upon APA range;
 - C the various term lengths for APAs, including rollback years, and the number of APAs with each such term length;
 - C the nature of documentation required; and
 - C approaches for sharing of currency or other risks.

The first report would cover the period January 1, 1991, through the calendar year including the date of enactment. The IRS user fee otherwise required to be paid for an APA would be increased by \$500. The Secretary would have the authority to provide an appropriate reduction in the IRS user fee for small businesses with respect to an APA. While the proposal statutorily requires an annual report, the proposal is not intended to discourage the Treasury Department from issuing other forms of guidance, such as regulations or revenue rulings, consistent with the confidentiality provisions of the Code.

Effective Date

The proposal would be effective on the date of enactment; accordingly, no APAs or related background file documents would be released to the public after the date of enactment. The first annual Treasury Department report would be required to be published no later than March 30, 2000.

K. Increase Dollar Limitation on Section 911 Exclusion

Present Law

U.S. citizens generally are subject to U.S. income tax on their worldwide income. A U.S. citizen who earns income in a foreign country also may be taxed on such income by that foreign country. A credit against the U.S. income tax imposed on foreign-source income is allowed for foreign taxes paid on such income.

U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs. In order to qualify for these exclusions, a U.S. citizen must be either (1) a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (2) present in a foreign country or countries for 330 days out of any 12 consecutive month period. In addition, the taxpayer must have his or her tax home in a foreign country.

The exclusion for foreign earned income generally applies to income earned from sources outside the United States as compensation for personal services actually rendered by the taxpayer. The maximum exclusion for foreign earned income for taxable years before 1998 is \$70,000. Beginning in 1998, the maximum exclusion is increased in increments of \$2,000 per year until the exclusion amount is \$80,000 (i.e., in the year 2002). The maximum exclusion is \$74,000 for 1999. The exclusion is indexed for inflation beginning in 2008 (for inflation after 2006).

The exclusion for housing costs applies to reasonable expenses, other than deductible interest and taxes, paid or incurred by or on behalf of the taxpayer for housing for the taxpayer and his or her spouse and dependents in a foreign country. The exclusion amount for housing costs for a taxable year is equal to the excess of such housing costs for the taxable year over an amount computed pursuant to a specified formula.

The combined earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income. The taxpayer's foreign tax credit is reduced by the amount of the credit that is attributable to excluded income.

Description of Proposal

The proposal would increase the maximum exclusion for foreign earned income in annual increments of \$3,000 per year beginning in 2003, until the exclusion amount is \$95,000 (i.e., in the year 2007). Thus, for the years 2003 through 2007, the maximum exclusion would gradually increase from \$83,000 to \$95,000. Beginning in 2008, the maximum exclusion amount of \$95,000 would be indexed for inflation.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

X. TAX-EXEMPT ORGANIZATION PROVISIONS

A. Provide Tax Exemption for Organizations Created by a State to Provide Property and Casualty Insurance Coverage for Property for Which Such Coverage Is Otherwise Unavailable

Present Law

A life insurance company is subject to tax on its life insurance company taxable income, which is its life insurance income reduced by life insurance deductions (sec. 801). Similarly, a property and casualty insurance company is subject to tax on its taxable income, which is determined as the sum of its underwriting income and investment income (as well as gains and other income items) (sec. 831). Present law provides that the term “corporation” includes an insurance company (sec. 7701(a)(3)).

In general, the Internal Revenue Service (“IRS”) takes the position that organizations that provide insurance for their members or other individuals are not considered to be engaged in a tax-exempt activity. The IRS maintains that such insurance activity is either (1) a regular business of a kind ordinarily carried on for profit, or (2) an economy or convenience in the conduct of members' businesses because it relieves the members from obtaining insurance on an individual basis.

Certain insurance risk pools have qualified for tax exemption under Code section 501(c)(6). In general, these organizations (1) assign any insurance policies and administrative functions to their member organizations (although they may reimburse their members for amounts paid and expenses); (2) serve an important common business interest of their members; and (3) must be membership organizations financed, at least in part, by membership dues.

State insurance risk pools may also qualify for tax exempt status under section 501(c)(4) as a social welfare organization or under section 115 as serving an essential governmental function of a State. In seeking qualification under section 501(c)(4), insurance organizations generally are constrained by the restrictions on the provision of “commercial-type insurance” contained in section 501(m). Section 115 generally provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.

Certain specific provisions provide tax-exempt status to organizations meeting statutory requirements.

Health coverage for high-risk individuals

Section 501(c)(26) provides tax-exempt status to any membership organization that is established by a State exclusively to provide coverage for medical care on a nonprofit basis to certain high-risk individuals, provided certain criteria are satisfied. The organization may provide

coverage for medical care either by issuing insurance itself or by entering into an arrangement with a health maintenance organization ("HMO").

High-risk individuals eligible to receive medical care coverage from the organization must be residents of the State who, due to a pre-existing medical condition, are unable to obtain health coverage for such condition through insurance or an HMO, or are able to acquire such coverage only at a rate that is substantially higher than the rate charged for such coverage by the organization. The State must determine the composition of membership in the organization. For example, a State could mandate that all organizations that are subject to insurance regulation by the State must be members of the organization.

The provision further requires the State or members of the organization to fund the liabilities of the organization to the extent that premiums charged to eligible individuals are insufficient to cover such liabilities. Finally, no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

Workers' compensation reinsurance organizations

Section 501(c)(27)(A) provides tax-exempt status to any membership organization that is established by a State before June 1, 1996, exclusively to reimburse its members for workers' compensation insurance losses, and that satisfies certain other conditions. A State must require that the membership of the organization consist of all persons who issue insurance covering workers' compensation losses in such State, and all persons and governmental entities who self-insure against such losses. In addition, the organization must operate as a nonprofit organization by returning surplus income to members or to workers' compensation policyholders on a periodic basis and by reducing initial premiums in anticipation of investment income.

State workmen's compensation act companies

Section 501(c)(27)(B) provides tax-exempt status for any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance, and that meets certain additional requirements. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive remedy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide workmen's compensation to any employer in the State (for employees in the State or temporarily assigned out-of-State) seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to the initial debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment, either the assets of the organization must revert to the State upon dissolution, or State law must not permit the dissolution of the organization absent an act of the State legislature. Should dissolution of the organization become permissible under applicable State law, then the requirement that the assets of the

organization revert to the State upon dissolution applies. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

Description of Proposal

The proposal would provide tax-exempt status for any association created before January 1, 1999, by State law and organized and operated exclusively to provide property and casualty insurance coverage for property located within the State for which the State has determined that coverage in the authorized insurance market is limited or unavailable at reasonable rates, provided certain requirements are met.

Under the proposal, no part of the net earnings of the association may inure to the benefit of any private shareholder or individual. Except as provided in the case of dissolution, no part of the assets of the association may be used for, or diverted to, any purpose other than: (1) to satisfy, in whole or in part, the liability of the association for, or with respect to, claims made on policies written by the association; (2) to invest in investments authorized by applicable law; or (3) to pay reasonable and necessary administration expenses in connection with the establishment and operation of the association and the processing of claims against the association. Under the proposal, it would be required that the State law governing the association permit the association to levy assessments on property and casualty insurance policyholders with insurable interests in property located in the State to fund deficits of the association, including the creation of reserves. Under the proposal, it would be required that the plan of operation of the association be subject to approval by the chief executive officer or other executive branch official of the State, by the State legislature, or both. In addition, it would be required that the assets of the association revert upon dissolution to the State, the State's designee, or an entity designated by the State law governing the association, or that State law not permit the dissolution of the association.

The proposal would provide a special rule in the case of any entity or fund created before January 1, 1999, pursuant to State law and organized and operated exclusively to receive, hold, and invest remittances from an association exempt from tax under the proposal and to make disbursements to pay claims on insurance contracts issued by the association. The special rule would provide that the entity or fund may elect to be disregarded as a separate entity and be treated as part of the association exempt from tax under the proposal, from which it receives such remittances. The election would be required to be made no later than 30 days following the date on which the association is determined to be exempt from tax under the proposal, and would be effective as of the effective date of that determination.

In the event that the association's surplus income for the taxable year exceeds 15 percent of the total coverage in force under insurance contracts issued by the association as of the close of the taxable year, the association would not be treated as exempt from tax under the proposal.

Under the proposal, no income or gain would be recognized solely as a result of the change in status to that of an association exempt from tax under the proposal.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

B. Conform Provisions Relating to Arbitrage Treatment to Reflect Proposed State Constitutional Amendments

Present Law

In general, present-law tax-exempt bond arbitrage restrictions provide that interest on a State or local government bond is not eligible for tax-exemption if the proceeds are invested, directly or indirectly, in materially higher yielding investments or if the debt service on the bond is secured by or paid from (directly or indirectly) such investments. An exception, enacted in 1984, provides that the pledge of income from investments in a Fund established under a provision of a State constitution adopted in 1876 as security for a limited amount of tax-exempt bonds will not cause interest on those bonds to be taxable. The terms of this exception are limited to State constitutional or statutory restrictions in effect as of October 9, 1969.

The Fund consists of certain State lands that were set aside for the benefit of higher education, the income from mineral rights to these lands, and certain other earnings on Fund assets. The State constitution directs that monies held in the Fund are to be invested in interest-bearing obligations and other securities. The constitution does not permit the expenditure or mortgage of the Fund for any purpose. Income from the Fund is apportioned between two university systems operated by the State. Tax-exempt bonds issued by the two university systems are secured by and payable from the income of the Fund. These bonds are used to finance buildings and other permanent improvements for the universities.

The General Assembly of the State has approved proposed constitutional amendments regarding the manner in which amounts in the Fund are paid for the benefit of the two university systems. These proposed amendments are to be voted on by the State's citizens in November 1999. If approved, the amendments will in substance eliminate the benefits of the 1984 exception from the tax-exempt bond arbitrage restrictions for future debt.

Description of Proposal

The 1984 exception would be conformed to the proposed State constitutional amendments to permit its continued applicability to bonds of the two university systems. Limitations on the aggregate amount of bonds which may benefit from the exception would not be modified.

Effective Date

The proposal would apply to bonds issued after December 31, 1999.

C. Denial of Charitable Contribution Deduction for Transfers Associated with Split-Dollar Insurance Arrangements

Present Law

Under present law, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities (sec. 170(c)). The term “contribution or gift” is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent. If a taxpayer receives or expects to receive a quid pro quo in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return, provided the excess payment is made with the intention of making a gift.⁶⁹

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer’s entire interest (i.e., a partial interest) in any property (sec. 170(f)(3)). In addition, no deduction is allowed for any contribution of \$250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization that includes a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration, whole or part, for the taxpayer’s contribution (sec. 170(f)(8)).

Description of Proposal

Deduction denial

The proposal⁷⁰ would restate present law to provide that no charitable contribution deduction is allowed for purposes of Federal tax, for a transfer to or for the use of an organization described in section 170(c) of the Internal Revenue Code, if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any “personal benefit contract” with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any “personal benefit contract” with respect to the transferor. It would be intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

⁶⁹ United States v. American Bar Endowment, 477 U.S. 105 (1986). Treas. Reg. sec. 1.170A-1(h).

⁷⁰ The proposal is similar to H.R. 630, introduced by Mr. Archer for himself and for Mr. Rangel (106th Cong., 1st Sess.).

A personal benefit contract with respect to the transferor would be any life insurance, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than a section 170(c) organization) designated by the transferor. For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It would be intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to a section 170(c) organization and designates one or more section 170(c) organizations as the sole beneficiaries under the contract, generally, it would not be intended that the deduction denial rule under the proposal apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor would be considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) would not prevent it from being a personal benefit contract. The proposal would not be intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It would be intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, as described below, an indirect beneficiary would not be intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of sec. 501(m)).

Under the proposal, an individual's family would consist of the individual's grandparents, the grandparents of the individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

In the case of a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund its obligation to pay the charitable gift annuity, a person receiving payments under the charitable gift annuity would not be treated as an indirect beneficiary, provided certain requirements are met. The requirements are that (1) the charitable organization possess all of the incidents of ownership (within the meaning of Treas. Reg. sec. 20.2042-1(c)) under the annuity contract purchased by the charitable organization; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable gift annuity obligation that is issued under the laws of a State that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that State, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that State, then the foregoing requirements (1) and (2) would be treated as if they are met, provided that certain additional requirements are met. The additional requirements are that the State law requirement was in effect on February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide

resident of the State at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and (as required by clause (iii) of subparagraph (D) of the proposal) the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)) that holds a life insurance, endowment or annuity contract issued by an insurance company, a person would not be treated as an indirect beneficiary under the contract held by the trust, solely by reason of being a recipient of an annuity or unitrust amount paid by the trust, provided that the trust possesses all of the incidents of ownership under the contract and is entitled to all the payments under such contract. No inference would be intended as to the applicability of other provisions of the Code with respect to the acquisition by the trust of a life insurance, endowment or annuity contract, or the appropriateness of such an investment by a charitable remainder trust.

Nothing in the proposal would be intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract, solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates.

Excise tax

The proposal would impose on any organization described in section 170(c) of the Code an excise tax, equal to the amount of the premiums paid by the organization on any life insurance, annuity, or endowment contract, if the premiums are paid in connection with a transfer for which a deduction is not allowable under the deduction denial rule of the proposal (without regard to when the transfer to the charitable organization was made). The excise tax would not apply if all of the direct and indirect beneficiaries under the contract (including any related side agreement) are organizations described in section 170(c). Under the proposal, payments would be treated as made by the organization, if they are made by any other person pursuant to an understanding or expectation of payment. The excise tax is to be applied taking into account rules ordinarily applicable to excise taxes in chapter 41 or 42 of the Code (e.g., statute of limitation rules).

Reporting

The proposal would require that the charitable organization annually report the amount of premiums that is paid during the year and that is subject to the excise tax imposed under the proposal, and the name and taxpayer identification number of each beneficiary under the life insurance, annuity or endowment contract to which the premiums relate, as well as other information required by the Secretary of the Treasury. For this purpose, it would be intended that a

beneficiary include any beneficiary under any side agreement to which the section 170(c) organization is a party (or of which it is otherwise aware). Penalties applicable to returns required under Code section 6033 apply to returns under this reporting requirement. Returns required under this proposal are to be furnished at such time and in such manner as the Secretary shall by forms or regulations require.

Regulations

The proposal would provide for the promulgation of regulations necessary or appropriate to carry out the purposes of the proposal, including regulations to prevent the avoidance of the purposes of the proposal. For example, it would be intended that regulations prevent avoidance of the purposes of the proposal by inappropriate or improper reliance on the limited exceptions provided for certain beneficiaries under bona fide charitable gift annuities and for certain noncharitable recipients of an annuity or unitrust amount paid by a charitable remainder trust.

Effective Date

The deduction denial proposal would apply to transfers after February 8, 1999 (as provided in H.R. 630). The excise tax proposal would apply to premiums paid after the date of enactment. The reporting proposal would apply to premiums paid after February 8, 1999 (determined as if the excise tax imposed under the proposal applied to premiums paid after that date).

No inference would be intended that a charitable contribution deduction is allowed under present law with respect to a charitable split-dollar insurance arrangement. The proposal would not change the rules with respect to fraud or criminal or civil penalties under present law; thus, actions constituting fraud or that are subject to penalties under present law would still constitute fraud or be subject to the penalties after enactment of the proposal.

D. Authorize Secretary of Treasury to Grant Waivers from Section 4941 Prohibitions

Present Law

In order to deter transactions between tax-exempt private foundations and certain related persons, present law provides for the imposition of excise taxes when “disqualified persons” engage in acts of “self-dealing” with a private foundation (sec. 4941). Disqualified persons include trustees, directors, foundation managers, substantial contributors to the foundation, and certain family members of these persons. Disqualified persons also include government officials at certain levels.

Acts of self-dealing include: (1) the sale, exchange, or leasing of property, (2) the lending of money or extensions of credit,⁷¹ (3) the furnishing of goods, services, or facilities,⁷² (4) the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person,⁷³ (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation, and (6) the agreement by a private foundation to make any payment of money or other property to a government official. There is no exception from the prohibition on acts of self-dealing for inadvertent violations, and even transactions which may benefit the private foundation may be subject to tax as an act of self-dealing. Thus, for example, a disqualified person may not rent space to a private foundation at a rate that is below the market.

Self-dealing excise taxes are imposed on a disqualified person who has engaged in a self-dealing transaction, and on any foundation manager who knowingly participates in the transaction.⁷⁴ At the first level of tax, a disqualified person is subject to an initial tax at a rate of 5 percent and a foundation manager at a rate of 2.5 percent (up to a maximum of \$10,000) of the “amount involved” in the act of self-dealing. Where the self-dealing transaction involves the use of money (e.g., a loan) or other property, the “amount involved” generally is the greater of the amount of money and

⁷¹ The lending of money to private foundation on an interest-free basis where the loan proceeds are to be used exclusively for charitable purposes is not an act of self-dealing.

⁷² A disqualified person may, however, furnish goods, services, or facilities to a private foundation at no charge. In addition, it is not an act of self-dealing for a private foundation to furnish goods, services, or facilities to a disqualified person on a basis no more favorable than available to the general public.

⁷³ Payment by a private foundation of compensation to a disqualified person (other than a government official) for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation is not an act of self-dealing.

⁷⁴ Except in the case of a government official, the excise tax is imposed on a disqualified person even though the person had no knowledge at the time of the act that it constituted self-dealing. In the case of a government official, however, the tax may be imposed only if the official participated in an act of self-dealing knowing that it was such an act.

the fair market value of the other property given or the amount of money and the fair market value of the property received.⁷⁵ Section 4941 also imposes a second level of taxes at higher rates where an act of self-dealing has occurred and the transaction is not corrected within a specified period of time. At the second level, a disqualified person is subject to a tax of 200 percent and a foundation manager is subject to a tax of 50 percent (up to a maximum of \$10,000) of the amount involved.

Description of Proposal

The proposal would require that the Secretary of the Treasury establish an exemption procedure pursuant to which the Secretary could grant a conditional or unconditional exemption from the self-dealing prohibition of section 4941. The Secretary would be permitted to grant an exemption for any disqualified person or transaction, or class of disqualified persons or transactions, if such exemption were: (1) administratively feasible, (2) in the interests of the private foundation, and (3) protective of the rights of the private foundation. The proposal would require that, prior to granting such an exemption, the Secretary must: (1) require that adequate notice be given to interested persons, (2) publish notice in the Federal Register of the pendency of a request for an exemption, and (3) afford interested persons an opportunity to present their views.

Effective Date

The proposal would be effective for transactions occurring after the date of enactment.

⁷⁵ For example, if a private foundation leases office space from a disqualified person, the amount involved is the greater of the amount of rent received by the disqualified person from the foundation or the fair rental value of the building for the period the building is used by the foundation.

E. Extend Declaratory Judgment Procedures to Non-501(c)(3) Tax-exempt Organizations

Present Law

In order for an organization to be granted tax exemption as a charitable entity described in section 501(c)(3), it generally must file an application for recognition of exemption with the IRS and receive a favorable determination of its status. Similarly, for most organizations, a charitable organization's eligibility to receive tax-deductible contributions is dependent upon its receipt of a favorable determination from the IRS. In general, a section 501(c)(3) organization can rely on a determination letter or ruling from the IRS regarding its tax-exempt status, unless there is a material change in its character, purposes, or methods of operation. In cases where an organization violates one or more of the requirements for tax exemption under section 501(c)(3), the IRS is authorized to revoke an organization's tax exemption, notwithstanding an earlier favorable determination.

In situations where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax status (sec. 7428). Section 7428 provides a remedy in the case of a dispute involving a determination by the IRS with respect to: (1) the initial qualification or continuing qualification of an organization as a charitable organization for tax exemption purposes or for charitable contribution deduction purposes; (2) the initial classification or continuing classification of an organization as a private foundation; (3) the initial classification or continuing classification of an organization as a private operating foundation; or (4) the failure of the IRS to make a determination with respect to (1), (2), or (3). A "determination" in this context generally means a final decision by the IRS affecting the tax qualification of a charitable organization, although it also can include a proposed revocation of an organization's tax-exempt status or public charity classification. Section 7428 vests jurisdiction over controversies involving such a determination in the U.S. District Court for the District of Columbia, the U.S. Court of Federal Claims, and the U.S. Tax Court.

Prior to utilizing the declaratory judgment procedure, an organization must have exhausted all administrative remedies available to it within the IRS. For the first 270 days after a request for a determination is made, an organization is deemed to not have exhausted its administrative remedies. Provided that no determination is made during the 270-day period, the organization may initiate an action for declaratory judgment after the period has elapsed. If, however, the IRS makes an adverse determination during the 270-day period, an organization may initiate a declaratory judgment immediately. The 270-day period does not begin with respect to applications for recognition of tax-exempt status until the date a substantially completed application is submitted.

In contrast to the rules governing charities, it is a disputed issue as to whether non-charities (i.e., organizations not described in section 501(c)(3), including trade associations, social welfare organizations, social clubs, labor and agricultural organizations, and fraternal organizations) are required to file an application with the IRS to obtain a determination of their tax-exempt status. If an organization voluntarily files an application for recognition of exemption and receives a

favorable determination from the IRS, the determination of tax-exempt status is usually effective as of the date of formation of the organization if its purposes and activities during the period prior to the date of the determination letter were consistent with the requirements for exemption. However, if the organization files an application for recognition of exemption and later receives an adverse determination from the IRS, the IRS may assert that the organization is subject to tax on some or all of its income for open taxable years. In addition, as with charitable organizations, the IRS may revoke or modify an earlier favorable determination regarding an organization's tax-exempt status.

Under present law, a non-charity (i.e., an organization not described in section 501(c)(3)) may not seek a declaratory judgment with respect to an IRS determination regarding its tax-exempt status. The only remedies available to such an organization are to petition the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay any tax owed and sue for refund in federal district court or the U.S. Court of Federal Claims.

Description of Proposal

The proposal would extend declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) determinations. Jurisdiction over controversies involving such determinations would be limited to the United States Tax Court.⁷⁶

Effective Date

The proposal would be effective for pleadings with respect to determinations made after the date of enactment.

⁷⁶ This limitation currently applies to declaratory judgments relating to tax qualification for certain employee retirement plans (sec. 7476).

F. Modify Section 512(b)(13)

Present Law

In general, interest, rents, royalties and annuities are excluded from the unrelated business income (“UBI”) of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, “control” means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includible in the latter organization's UBI and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

The Taxpayer Relief Act of 1997 (the “1997 Act”) made several modifications, as described above, to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Description of Proposal

The proposal would provide that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization in the latter organization’s UBI, applies only to the portion of payments received in a taxable year that exceed the amount of the specified payment which would have been paid if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) would be included in the parent organizations’s UBI. In addition, the proposal would impose a 20 percent penalty on the excess amount of any such payment.

The proposal would provide relief for payments under contracts which, on the date of enactment of the proposal, are subject to the binding contract transition rule of the 1997 Act, but for which the transition rule would expire prior to the effective date of the proposal, by extending the

transition rule until December 31, 1999.

Effective Date

The proposal providing an exception from the general rule of section 512(b)(13) for interest, rent, annuity, or royalty payments from controlled subsidiaries that do not exceed fair market value generally would apply to payments received or accrued in taxable years beginning after December 31, 1999.

XI. REAL ESTATE RELIEF PROVISIONS

A. Proposals Relating to REITs

Present Law

Real estate investment trust (“REITs”) are treated, in substance, as pass-through entities under present law. Pass-through status is achieved by allowing the REIT a deduction for dividends paid to its shareholders. REITs are restricted to investing in passive investments primarily in real estate and securities. Specifically, a REIT is required to receive at least 95 percent of its income from real property rents and from securities. Amounts received as impermissible “tenant services income” are not treated as rents from real property. In general, such amounts are for services rendered to tenants that are not “customarily furnished” in connection with the rental of real property. Special rules permit amounts to be received from certain “foreclosure property,” treated as such for 3 years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or on indebtedness which such property secured.

A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

A REIT is limited in the amount that it can own in other corporations. Specifically, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities of any corporate issuer. Under an exception to this rule, a REIT can own 100 percent of the stock of a corporation, but in that case the income and assets of such corporation are treated as income and assets of the REIT. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.⁷⁷

A REIT is generally required to distribute 95 percent of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies (“RICs”) that requires distribution of 90 percent of income. Both REITS and RICs can make certain “deficiency dividends” after the close of the taxable year, and have these treated as made before the end of the year. The regulations applicable to REITS state that a distribution will be treated as a “deficiency dividend” and thus as made before the end of the prior taxable year, only to the extent the earnings and profits for that year exceed the amount of distributions actually made during the taxable year.

⁷⁷ 15 U.S.C. 80a-1 and following.

A REIT that has been or has combined with a C corporation will be disqualified if, as of the end of its taxable year, it has accumulated earnings and profits from a non-REIT year. A similar rule applies to regulated investment companies (“RICs”). In the case of a REIT, any distribution made in order to comply with this requirement is treated as being first from pre-REIT accumulated earnings and profits. RICs do not have a similar ordering rule.

In the case of a RIC, under a provision entitled “procedures similar to deficiency dividend procedures”, any distribution made within a specified period after determination that the investment company did not qualify as a RIC for the taxable year will, “for purposes of applying [the earnings and profits rule that forbids a RIC to have non-RIC earnings and profits] to subsequent taxable years”, be treated as applying to the RIC for the non-RIC year. The REIT rules do not specify any particular separate treatment of distributions made after the end of the taxable year for purposes of the earnings and profits rule. Treasury regulations under the REIT provisions state that “distribution procedures similar to those ... for regulated investment companies apply to non-REIT earnings and profits of a real estate investment trust.”

Description of Proposal

Taxable REIT subsidiaries

Under the proposal, a REIT generally could not own more than 10 percent of the total value of securities of a single issuer, in addition to the present law limit of the REIT’s ownership to no more than 10 percent of the outstanding voting securities of a single issuer.

For purposes of the new 10 percent value test, securities would generally be defined to exclude safe harbor debt owned by a REIT (as defined for purposes of section 1361(c)(5)(B)(i) and (ii)) if the REIT (and any taxable REIT subsidiary of such REIT) owns no other securities of the issuer. In the case of a REIT that owns securities of a partnership, safe harbor debt would be excluded from the definition of securities only if the REIT owns at least 20 percent or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20 percent profits interest is to assure that if the partnership produces income that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly, even though it may also derive qualified interest income through its safe harbor debt interest.

An exception to the limitations on ownership of securities of a single issuer would apply in the case of a “taxable REIT subsidiary” that meets certain requirements. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT) of which a taxable REIT subsidiary owns, directly or indirectly, more than 35 percent of the vote or value is automatically treated as a taxable REIT subsidiary. Securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries could not exceed 25 percent of the total value of a REIT’s assets.

A taxable REIT subsidiary would be able to engage in certain business activities that under present law could disqualify the REIT because, but for the proposal, the taxable REIT subsidiary’s activities and relationship with the REIT could prevent certain income from qualifying as rents

from real property. Specifically, the subsidiary could provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and could manage or operate properties generally, without causing amounts received or accrued directly or indirectly by REIT for such activities to fail to be treated as rents from real property.

However, the subsidiary could not directly or indirectly operate or manage a lodging or healthcare facility. Nevertheless, it could lease a qualified lodging facility (e.g, a hotel) from the REIT (provided no gambling revenues were derived by the hotel or on its premises); and the rents paid would be treated as rents from real property so long as the lodging facility was operated by an independent contractor for a fee. The subsidiary could bear all expenses of operating the facility and receive all the net revenues, minus the independent contractor's fee.

For purposes of the rule that an independent contractor may operate a qualified lodging facility, an independent contractor will qualify so long as, at the time it enters into the management agreement with the taxable REIT subsidiary, it is actively engaged in the trade or business of operating qualified lodging facilities for any person who is not related to the REIT or the taxable REIT subsidiary. The REIT may receive income from such an independent contractor with respect to certain pre-existing leases.

Also, the subsidiary generally could not provide to any person rights to any brand name under which hotels or healthcare facilities are operated. An exception applies to rights provided to an independent contractor to operate or manage a lodging facility, if the rights are held by the subsidiary as licensee or franchisee, and the lodging facility is owned by the subsidiary or leased to it by the REIT.

Interest paid by a taxable REIT subsidiary to the related REIT would be subject to the earnings stripping rules of section 163(j). Thus the taxable REIT subsidiary could not deduct interest in any year that would exceed 50 percent of the subsidiary's adjusted gross income.

If any amount of interest, rent, or other deductions of the taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arm's length ("redetermined" items) , an excise tax of 100% would be imposed on the portion that was excessive. "Safe harbors" would be provided for certain rental payments where the amounts are de minimis, there is specified evidence that charges to unrelated parties are substantially comparable, certain charges for services from the taxable REIT subsidiary are separately stated, or the subsidiary's gross income from the service is not less than 150 percent of the subsidiary's direct cost in furnishing the service.

In determining whether rents are arm's length rents, the fact that such rents do not meet the requirements of the specified safe harbors shall not be taken into account. In addition, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

The Commissioner of Internal Revenue is to conduct a study to determine how many taxable REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries. The

Commissioner shall submit a report to the Congress describing the results of such study.

Health Care REITS

The proposal would permit a REIT to own and operate a health care facility for at least two years, and treat it as permitted “foreclosure” property, if the facility is acquired by the termination or expiration of a lease of the property. Extensions of the 2 year period could be granted.

Conformity with regulated investment company rules

The REIT distribution requirements would be modified to conform to the rules for regulated investment companies. Specifically, a REIT would be required to distribute only 90 percent, rather than 95 percent, of its income.

Definition of independent contractor

If any class of stock of the REIT or the person being tested as an independent contractor is regularly traded on an established securities market, only persons who directly or indirectly own 5 percent or more of such class of stock shall be counted in determining whether the 35 percent ownership limitations have been exceeded.

Modification of earnings and profits rules for RICs and REITS

The rule allowing a RIC to make a distribution after a determination that it had failed RIC status, and thus meet the requirement of no non-RIC earnings and profits in subsequent years, would be modified to clarify that, when reason for the determination is that the RIC had non-RIC earnings and profits in the initial year, the procedure would apply to permit RIC qualification in the initial year to which such determination applied, in addition to subsequent years.

The RIC earnings and profits rules would also be modified to provide an ordering rule similar to the REIT rule, treating a distribution to meet the requirements of no non-RIC earnings and profits as coming first from the earliest earnings and profits accumulated in any year for which the RIC did not qualify as a RIC.

The rule regarding ordering of REIT distributions to cure a failure to distribute non-REIT earnings and profits would be included as part of the REIT deficiency dividend procedure, thereby providing that all REIT distributions (including those made after the end of a taxable year under a deficiency dividend procedure) will be deemed to come from accumulated earnings and profits first if made for the purpose of curing such failure.

Effective Date

The proposal would generally be effective for taxable years beginning after December 31, 2000. The proposal with respect to modification of earnings and profits rules would be effective

for distributions after December 31, 2000.

In the case of the provisions relating to permitted ownership of securities of an issuer, special transition rules apply. The new rules forbidding a REIT to own more than 10 percent of the value of securities of a single issuer would not apply to a REIT with respect to securities held directly or indirectly by such REIT on July 12, 1999, or acquired pursuant to the terms of a written binding contract in effect on that date and at all times thereafter until the acquisition. Also, securities received in a tax-free exchange or reorganization, with respect to or in exchange for such grandfathered securities would be grandfathered. This transition would cease to apply to securities of a corporation as of the first day after July 12, 1999 on which such corporation engages in a substantial new line of business, or acquires any substantial asset, other than pursuant to a binding contract in effect on such date and at all times thereafter, or in a reorganization or transaction in which gain or loss is not recognized by reason of section 1031 or 1033 of the Code. If a corporation makes an election to become a taxable REIT subsidiary, effective before January 1, 2004 and at a time when the REIT's ownership is grandfathered under these rules, the election would be treated as a reorganization under section 368(a)(1)(A) of the Code.

B. Modify At-Risk Rules for Publicly Traded Securities

Present Law

Present law provides an at-risk limitation on losses from business and income-producing activities, applicable to individuals and certain closely held corporations (sec. 465). Under the at-risk rules, a taxpayer generally is not considered at risk with respect to borrowed amounts if the taxpayer is not personally liable for repayment of the debt (e.g., nonrecourse loans), and in certain other circumstances.

In the case of the activity of holding real property, however, an exception is provided for qualified nonrecourse financing that is secured by real property used in the activity (sec. 465(b)(6)). The qualified nonrecourse financing rules require, among other things, that the financing be borrowed by the taxpayer from a qualified person or from certain governmental entities. For this purpose, a qualified person is one that is actively and regularly engaged in the business of lending money (and that is not a related person with respect to the taxpayer, is not a person from whom the taxpayer acquired the property or a related person, and is not a person that receives a fee with respect to the taxpayer's investment or a related person (sec. 49(a)(1)(D)(iv)). A related person is one with certain types of relationships to the taxpayer defined by statute (sec. 465(b)(3)(C)). The qualified nonrecourse financing rules also require that the financing be secured by real property used in the activity (sec. 465(b)(6)(A)).

It is understood that the rule requiring that the financing be borrowed from a person that is actively and regularly engaged in the business of lending money hinders the use of publicly traded debt in real estate financing to which the at-risk rules apply, because absent restrictions on sale of the debt, the holders of publicly traded debt could be persons other than those who are actively and regularly engaged in the business of lending money (even though such persons are not related persons). In addition, it is understood that publicly traded debt may often be debt that is not mortgage debt and is not otherwise secured by real property used in the real estate activity.

Description of Proposal

The proposal would modify the rules relating to qualified nonrecourse financing to provide that, in the case of an activity of holding real property, a taxpayer is considered at risk with respect to the taxpayer's share of certain financing that is not borrowed from a person that is regularly engaged in the business of lending money, and that is not secured by real property used in the activity, if the financing is qualified publicly traded debt.

The financing may not be borrowed from a person that is a related person with respect to the taxpayer, that is a person from whom the taxpayer acquired the property or a related person, or that is a person that receives a fee with respect to the taxpayer's investment or a related person.

Qualified publicly traded debt would generally mean any debt instrument that is readily tradable on an established securities market. However, qualified publicly traded debt would not

include any debt instrument, the yield to maturity on which equals or exceeds the applicable Federal rate of interest for the calendar month in which it is issued, plus 5 percentage points. The applicable Federal rate would be the rate determined under section 1274(d) with respect to the term of the debt instrument. Under the proposal, it would be intended that “readily tradable on an established securities market” have the same meaning as under section 453(f)(5).

Effective Date

The proposal would be effective for debt instruments issued after December 31, 1999.

C. Qualified Lessee Construction Allowances Not Limited to Short-term Leases for Certain Retailers

Present Law

Section 110 provides that the gross income of a lessee does not include amounts received in cash (or treated as a rent reduction) from a lessor under a short-term lease of retail space for the purpose of the lessee's construction or improvement of qualified long-term real property for use in the lessee's trade or business at the retail space subject to the short-term lease. The exclusion only applies to the extent the allowance does not exceed the amount expended by the lessee on the construction or improvement of qualified long-term real property. For this purpose, "qualified long-term real property" means nonresidential real property that is part of, or otherwise present at, retail space used by the lessee and that reverts to the lessor at the termination of the lease. A "short-term lease" means a lease or other agreement for the occupancy or use of retail space for a term of 15 years or less (as determined pursuant to sec. 168(i)(3)). "Retail space" means real property leased, occupied, or otherwise used by the lessee in its trade or business of selling tangible personal property or services to the general public.

The lessor must treat the amounts expended on the construction allowance as nonresidential real property owned by the lessor. The Secretary is granted the authority to require reporting to ensure that both the lessor and lessee treat such amounts as nonresidential real property owned by the lessor.⁷⁸

Description of Proposal

The proposal would eliminate the section 110 requirement that the lease be for a term of 15 years or less in the case of payment (or rent reduction) to a "qualified retail business." Payments by a lessor to such businesses for the purpose of constructing or improving long-term real property would not be included in the income of the lessee regardless of the term of the lease, provided the payments are used for such purpose.

A qualified retail business would be defined as a trade or business of selling tangible personal property to the general public. A trade or business will not fail to be considered a qualified retail business by reason of sales of services to the general public if such sales are incidental to the sale of tangible personal property (such as tailoring services provided incidental to the sale of a suit or dress) or are de minimis in amount. For this purpose, services would be considered de minimis in amount if they represent 10 percent or less of the gross receipts of the business at the retail space subject to the lease.

⁷⁸Section 110 provides for regulations to be issued establishing the time and manner information must be provided the Secretary concerning amounts received (or treated as a rent reduction), amounts expended on qualified long-term real property, and such other information as the Secretary deems necessary to carry out the provision. These regulations have not yet been issued.

The proposal would not eliminate the short-term lease requirement in all situations that are otherwise eligible for section 110 under present law. Section 110 presently applies (assuming the other standards are met) if the retail space of the lessee will be used in the trade or business of selling tangible personal property or services to the public. If the lessee will earn more than 10 percent of the gross receipts of the space from the sale of services (other than from services that are incidental to the sale of tangible personal property), section 110 would continue to be available only if the lease is for a term of 15 years or less.

Effective Date

The proposal would apply to leases entered into after December 31, 1999. No inference is intended as to the treatment of amounts that are not affected by the proposal.

D. Exclusion From Gross Income for Certain Contributions to the Capital of Certain Retailers

Present Law

Section 118 provides that gross income does not include any contribution to the capital of a corporation. The test for determining whether a particular payment is a contribution to capital is the intent or motive of the transferor. The contribution (1) must become a part of the recipient's capital structure; (2) may not be compensation for a "specific, quantifiable service"; (3) must be bargained for; (4) must result in a benefit to the recipient; and (5) ordinarily will contribute to the production of additional income. United States v. Chicago, Burlington & Quincy R.R., 412 U.S. 401, 411, 93 S. Ct. 2169, 2175, 37 L. Ed. 2d 30 (1973).

Two appellate courts have applied section 118(a) to inducements paid by developers to retailers in exchange for the agreement of the retailers to "anchor" future shopping centers. Federated Department Stores v. Commissioner 51 TC 500 (1968), aff'd 426 F. 2d 417 (6th Cir., 1970), May Department Stores Co. v. Commissioner, 33 TCM 1128 (1974), aff'd 519 F. 2d 1154 (8th Cir., 1975). In both cases, the courts held that the benefits anticipated by the developer were speculative and intangible, and thus could not be considered in payment for any particular service.

The recipient taxpayer is allowed no basis in any property it receives as a contribution to capital, or in any property it acquires within 12 months with the proceeds of a contribution to capital (sec. 362).

Description of Proposal

The proposal would establish a safe harbor allowing certain inducements received by retailers in exchange for the retailer's agreement to operate a qualified retail business at particular location for a period of at least 15 years to be treated as nontaxable contributions to capital. In order to qualify for the safe harbor the retailer must, immediately after the receipt of the contribution, own the land and structures to be used by the taxpayer in carrying on the qualified retail business at the agreed location and must satisfy an expenditure rule. The safe harbor would not apply if the contributor owns a beneficial interest in property located on the premises of the qualified retail business, other than de minimis amounts of property associated with the operation of adjacent property. The expenditure rule requires that, prior to the end of the second taxable year after the year in the contribution was received, the retailer spend an amount equal to the amount of the contribution for the acquisition of land or structure, or for the acquisition or construction of other property to be used in the qualified retail business at the agreed location. Accurate records would be required to be kept that establish the satisfaction of the expenditure rule.

A qualified retail business would be defined as a trade or business of selling tangible personal property to the general public. A trade or business will not fail to be considered a qualified retail business by reason of sales of services to the general public if such sales are incidental to the sale of tangible personal property (such as tailoring services provided incidental

to the sale of a suit or dress) or are de minimis in amount. For this purpose, services would be considered de minimis in amount if they represent 10 percent or less of the gross receipts of the business at the retail space subject to the lease.

Anti-abuse rules would be provided to prevent the use of the safeharbor for amounts that are not intended by the parties as contributions to capital. The Secretary would be authorized to allocate income and deductions, or reduce the amount of any contribution to capital under the safeharbor, in cases in which it is established that above market rates have been paid from the retailer to the developer in another transaction⁷⁹. Similarly, the Secretary is authorized to allocate income and deductions, or reduce the amount of any contribution to capital, between related parties to the extent necessary to prevent the abuse of the purposes of this section.

Effective Date

The proposal would be effective for contributions received after December 31, 1999.

⁷⁹A rate would not be expected to be considered to be above market if it is the same on a square footage basis as the rate charged other retailers at the same location. For example, a developer charges all retailers in the mall a common area maintenance charge. If this charge is equal to a standard rate times the square footage of each store in the mall, it will not be considered to be an above market rate with respect to any single retailer.

XII. PENSION REFORM PROVISIONS

A. Expanding Coverage

1. Increase contribution and benefit limits

Present Law

In general

Under present law, limits apply to contributions and benefits under qualified plans (sec. 415), the amount of compensation that may be taken into account under a plan for determining benefits (sec. 401(a)(17)), the maximum amount of elective deferrals that an individual may make to a salary reduction plan or tax sheltered annuity (sec. 402(g)), and deferrals under an eligible deferred compensation plan of a tax-exempt organization or a State or local government (sec. 457).

Limitations on contributions and benefits

Under present law, the limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) \$30,000 (for 1999). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The \$30,000 limit is indexed for cost-of-living adjustments in \$5,000 increments.

Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100 percent of average compensation, or (2) \$130,000 (for 1999). The dollar limit is adjusted for cost-of-living increases in \$5,000 increments.

Under present law, in general, the dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age (currently, age 65) and increased if benefits begin after social security retirement age.⁸⁰

Compensation limitation

Under present law, the annual compensation of each participant that may be taken into account for purposes of determining contributions and benefits under a plan, applying the deduction rules, and for nondiscrimination testing purposes is limited to \$160,000 (for 1999). The

⁸⁰ An overall limit applies if a participant participates in a defined contribution plan and a defined benefit plan maintained by the same employer (sec. 415(e)). This limit is repealed for years beginning after December 31, 1999.

compensation limit is indexed for cost-of-living adjustments in \$10,000 increments.

Elective deferral limitations

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a “section 401(k) plan”), a tax-sheltered annuity (“section 403(b) annuity”) or a salary reduction simplified employee pension plan (“SEP”) is \$10,000 (for 1999). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is \$6,000. These limits are indexed for inflation in \$500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a “section 457 plan”) is the lesser of (1) \$8,000 (for 1999) or (2) 33-1/3 percent of compensation. The \$8,000 dollar limit is increased for inflation in \$500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant’s last 3 years before retirement, the otherwise applicable limit is increased to the lesser of (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

Description of Proposal

Limits on contributions and benefits

The proposal would increase the \$30,000 annual addition limit for defined contribution plans to \$40,000. This amount would be indexed in \$1,000 increments.⁸¹

The proposal would increase the \$130,000 annual benefit limit under a defined benefit plan to \$160,000. The dollar limit would be reduced for benefit commencement before age 62 and increased for benefit commencement after age 65.

Compensation limitation

The proposal would increase the limit on compensation that may be taken into account under a plan to \$200,000. This amount would be indexed in \$5,000 increments.

⁸¹ The 25 percent of compensation limitation would be increased to 100 percent of compensation under another section of the proposal.

Elective deferral limitations

Beginning in 2001, the proposal would increase the dollar limit on annual elective deferrals under section 401(k) plans, section 403(b) annuities and salary reduction SEPs in \$1,000 annual increments until the limits reach \$15,000 in 2005. Beginning in 2001, the proposal would increase the maximum annual elective deferrals that could be made to a SIMPLE plan in \$1,000 annual increments until the limit reaches \$10,000 in 2004. The \$15,000 and \$10,000 dollar limits would be indexed in \$500 increments, as under present law.

Section 457 plans

The proposal would increase the dollar limit on deferrals under a section 457 plan to conform to the elective deferral limitation. Thus, the limit would be \$11,000 in 2001, and would increase in \$1,000 annual increments until the limit reaches \$15,000 in 2005. The limit would be indexed thereafter in \$500 increments. The limit would be twice the otherwise applicable dollar limit in the three years prior to retirement.⁸²

Effective Date

The proposal would be effective for years beginning after December 31, 2000, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement.

2. Plan loans for Subchapter S shareholders, partners, and sole proprietors

Present Law

The Internal Revenue Code prohibits certain transactions (“prohibited transactions”) between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries.⁸³ Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan to plan participants, if certain requirements are satisfied. In addition, the Department of Labor can grant an administrative exemption from the prohibited transaction rules if she finds the exemption is administratively feasible, in the interest of the plan and plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. Pursuant to this exemption process, the Secretary of Labor grants exemptions both with respect to specific transactions and classes of transactions.

⁸² Another provision of the proposal would increase the 33-1/3 percentage of compensation limit to 100 percent.

⁸³ Title I of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) also contains prohibited transaction rules. The Code and ERISA provisions are substantially similar, although not identical.

The statutory exemptions to the prohibited transaction rules do not apply to transactions in which the plan makes a loan to an owner-employee.⁸⁴ Thus, owner-employees wishing to engage in such a transaction with a plan must obtain an administrative exemption. For purposes of these rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10 percent of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than the corporation, and (4) the owner of an individual retirement arrangement (“IRA”). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Internal Revenue Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period, and is equal to 100 percent of the amount involved.

Description of Proposal

The proposal would generally eliminate the special present-law rules relating to plan loans made to an owner-employee. Thus, the general statutory exemption would apply to such transactions. Present law would apply with respect to IRAs.

Effective Date

The proposal would be effective with respect to transactions entered into after December 31, 2000.

3. Modification of top-heavy rules

Present Law

In general

Under present law, additional qualification requirements apply to plans that primarily benefit an employer’s key employees (“top-heavy plans”). These additional requirements provide (1) more rapid vesting for plan participants who are non-key employees and (2) minimum nonintegrated employer contributions or benefits for plan participants who are non-key employees.

Definition of top-heavy plan

In general, a top-heavy plan is a plan under which more than 60 percent of the contributions or benefits are provided to key employees. More precisely, a defined benefit plan is a top-heavy plan if more than 60 percent of the cumulative accrued benefits under the plan are for key employees. A defined contribution plan is top heavy if the sum of the account balances of key

⁸⁴ Certain transactions involving a plan and Subchapter S shareholders are permitted.

employees is more than 60 percent of the total account balances under the plan. For each plan year, the determination of top-heavy status generally is made as of the last day of the preceding plan year (“the determination date”).

For purposes of determining whether a plan is a top-heavy plan, benefits derived both from employer and employee contributions, including employee elective contributions, are taken into account. In addition, the accrued benefit of a participant in a defined benefit plan and the account balance of a participant in a defined contribution plan includes any amount distributed within the 5-year period ending on the determination date.

An individual’s accrued benefit or account balance is not taken into account in determining whether a plan is top-heavy if the individual has not performed services for the employer during the 5-year period ending on the determination date.

In some cases, two or more plans of a single employer must be aggregated for purposes of determining whether the group of plans is top-heavy. The following plans must be aggregated: (1) plans which cover a key employee (including collectively bargained plans); and (2) any plan upon which a plan covering a key employee depends for purposes of satisfying the Code’s nondiscrimination rules. The employer may be required to include terminated plans in the required aggregation group. In some circumstances, an employer may elect to aggregate plans for purposes of determining whether they are top heavy.

SIMPLE plans are not subject to the top-heavy rules.

Definition of key employee

A key employee is an employee who, during the plan year that ends on the determination date or any of the 4 preceding plan years, is (1) an officer earning over one-half of the defined benefit plan dollar limitation of section 415 (\$65,000 for 1999), (2) a 5-percent owner of the employer, (3) a 1-percent owner of the employer earning over \$150,000, or (4) one of the 10 employees earning more than the defined contribution plan dollar limit (\$30,000 for 1999) with the largest ownership interests in the employer.

Minimum benefit for non-key employees

A minimum benefit generally must be provided to all non-key employees in a top-heavy plan. In general, a top-heavy defined benefit plan must provide a minimum benefit equal to the lesser of (1) 2 percent of compensation multiplied by the employee’s years of service, or (2) 20 percent of compensation. A top-heavy defined contribution plan must provide a minimum annual contribution equal to the lesser of (1) 3 percent of compensation, or (2) the percentage of compensation at which contributions were made for key employees (including employee elective contributions made by key employees and employer matching contributions).

For purposes of the minimum benefit rules, only benefits derived from employer contributions (other than amounts employees have elected to defer) to the plan are taken into

account, and an employee's social security benefits are disregarded (i.e., the minimum benefit is nonintegrated). Employer matching contributions may be used to satisfy the minimum contribution requirement; however, in such a case the contributions are not treated as matching contributions for purposes of applying the special nondiscrimination requirements applicable to employee elective contributions and matching contributions under sections 401(k) and (m). Thus, such contributions would have to meet the general nondiscrimination test of section 401(a)(4).⁸⁵

Top-heavy vesting

Benefits under a top-heavy plan must vest at least as rapidly as under one of the following schedules: (1) 3-year cliff vesting, which provides for 100 percent vesting after 3 years of service; and (2) 2-6 year graduated vesting, which provides for 20 percent vesting after 2 years of service, and 20 percent more each year thereafter so that a participant is fully vested after 6 years of service.⁸⁶

Qualified cash or deferred arrangements

Under a qualified cash or deferred arrangement (a "section 401(k) plan"), an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements, which compares the elective deferrals of highly compensated employees with elective deferrals of nonhighly compensated employees. (This test is called the actual deferral percentage test or the "ADP" test). Employer matching contributions under qualified defined contribution plans are also subject to a similar nondiscrimination test. (This test is called the actual contribution percentage test or the "ACP" test.)

Under a design-based safe harbor, a cash or deferred arrangement is deemed to satisfy the ADP test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule for qualified cash or deferred arrangements if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules (sec. 401(1)). A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to 3 percent of compensation and

⁸⁵ Tres. Reg. sec. 1.416-1 Q&A M-19.

⁸⁶ Benefits under a plan that is not top heavy must vest at least as rapidly as under one of the following schedules: (1) 5-year cliff vesting; and (2) 3-7 year graded vesting, which provides for 20 percent vesting after 3 years and 20 percent more each year thereafter so that a participant is fully vested after 7 years of service.

(b) 50 percent of the employee's elective deferrals from 3 to 5 percent of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for cash or deferred arrangements are deemed to satisfy the ACP test. Certain additional matching contributions are also deemed to satisfy the ACP test.

Description of Proposal

Definition of top-heavy plan

The proposal would provide that a plan consisting of a cash-or-deferred arrangement that satisfies the design-based safe harbor for such plans and matching contributions that satisfy the safe harbor rule for such contributions is not a top-heavy plan. Matching or nonelective contributions provided under such a plan could be taken into account in satisfying the minimum contribution requirements applicable to top-heavy plans.

In determining whether a plan is top-heavy, the proposal would provide that distributions during the year ending on the date the top-heavy determination is being made are taken into account. The present-law 5-year rule would apply with respect to in-service distributions. Similarly, the proposal would provide that an individual's accrued benefit or account balance is not taken into account if the individual has not performed services for the employer during the 1-year period ending on the date the top-heavy determination is being made.

Definition of key employee

The proposal would (1) provide that an employee is not considered a key employee by reason of officer status unless the employee earns more than \$150,000 in compensation for the year, and (2) repeal the top-10 owner key employee category.

The proposal would repeal the 4-year lookback rule for determining key employee status and provide that an employee is a key employee only if he or she is a key employee during the current plan year.

Minimum benefit for non-key employees

Under the proposal, matching contributions would be taken into account in determining whether the minimum benefit requirement has been satisfied.⁸⁷

The proposal would provide that, in determining the minimum benefit required under a defined benefit plan, a year of service would not include any year in which no employee benefits

⁸⁷ Thus, this provision would override the provision in Treasury regulations that, if matching contributions are used to satisfy the minimum benefit requirement, then they are not treated as matching contributions for purposes of the section 401(m) nondiscrimination rules.

under the plan (as determined under sec. 410).

Effective Date

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

4. Elective deferrals not taken into account for purposes of deduction limits

Present Law

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction limits, employee elective deferral contributions to a section 401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.

Description of Proposal

Under the proposal, elective deferral contributions would not be subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan would not take into account elective deferral contributions.

Effective Date

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

5. Reduce PBGC premiums for small and new plans

Present Law

Under present law, the Pension Benefit Guaranty Corporation (“PBGC”) provides insurance protection for participants and beneficiaries under certain defined benefit pension plans by guaranteeing certain basic benefits under the plan in the event the plan is terminated with insufficient assets to pay benefits promised under the plan. The guaranteed benefits are funded in part by premium payments from employers who sponsor defined benefit plans. The amount of the required annual PBGC premium for a single-employer plan is generally a flat rate premium of \$19 per participant and an additional variable rate premium based on a charge of \$9 per \$1,000 of unfunded vested benefits. Unfunded vested benefits under a plan generally means (1) the unfunded current liability for vested benefits under the plan, over (2) the value of the plan’s assets, reduced by any credit balance in the funding standard account. No variable rate premium is imposed for a year if contributions to the plan were at least equal to the full funding limit.

The PBGC guarantee is phased in ratably in the case of plans that have been in effect for less than 5 years, and with respect to benefit increases from a plan amendment that was in effect for less than 5 years before termination of the plan.

Description of Proposal

Reduced flat-rate premiums for new plans of small employers

Under the proposal, for the first five plan years of a new single-employer plan of a small employer, the flat-rate PBGC premium would be \$5 per plan participant.

A small employer would be a contributing sponsor that, on the first day of the plan year, has 100 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor would be taken into account. In the case of a plan to which more than one unrelated contributing sponsor contributes, employees of all contributing sponsors (and their controlled group members) would be taken into account in determining whether the plan is a plan of a small employer.

A new plan would mean a defined benefit plan maintained by a contributing sponsor if, during the 36-month period ending on the date of adoption of the plan, such contributing sponsor (or controlled group member or a predecessor of either) has not established or maintained a plan subject to PBGC coverage with respect to which benefits were accrued for substantially the same employees as are in the new plan.

Reduced variable PBGC premium for new and small employer plans

The proposal would provide that the variable premium is phased in for “new defined benefit plans” over a six-year period starting with the plan’s first plan year. The amount of the

variable premium would be a percentage of the variable premium otherwise due, as follows: 0 percent of the otherwise applicable variable premium in the first plan year; 20 percent in the second plan year; 40 percent in the third plan year; 60 percent in the fourth plan year; 80 percent in the fifth plan year; and 100 percent in the sixth plan year (and thereafter).

A new defined benefit plan would be defined as under the flat-rate premium proposal relating to new small employer plans.

The proposal would also provide that, in the case of any plan (not just a new plan) of an employer with 25 or fewer employees, the variable-rate premium is no more than \$5 multiplied by the number of plan participants.

Effective Date

The proposals relating to new plans would be effective for plans established after December 31, 2000. The proposal reducing the PBGC variable premium for small plans would be effective for years after December 31, 2000.

6. Repeal of coordination requirements for deferred compensation plans of State and local governments and tax-exempt organizations

Present Law

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or State and local government employer (a “section 457 plan”) is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) \$8,000 (in 1999) or (2) 33-1/3 percent of compensation. The \$8,000 limit is increased for inflation in \$500 increments. Under a special catch-up rule, a section 457 plan may provide that, for one or more of the participant’s last 3 years before retirement, the otherwise applicable limit is increased to the lesser of (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

The \$8,000 limit (as modified under the catch-up rule), applies to all deferrals under all section 457 plans in which the individual participates. In addition, in applying the \$8,000 limit, contributions under a tax-sheltered annuity (“section 403(b) annuity”), elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”), salary reduction contributions under a simplified employee pension plan (“SEP”), and contributions under a SIMPLE plan are taken into account. Further, the amount deferred under a section 457 plan is taken into account in applying a special catch-up rule for section 403(b) annuities.

Description of Proposal

The proposal would repeal the rules coordinating the section 457 dollar limit with

contributions under other types of plans.⁸⁸

Effective Date

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

7. Eliminate IRS user fees for determination letter requests regarding small employer plans

Present Law

An employer that maintains a retirement plan for the benefit of its employees may request from the Internal Revenue Service (“IRS”) a determination as to whether the form of the plan satisfies the requirements applicable to tax-qualified plans (sec. 401(a)). In order to obtain from the IRS a determination letter on the qualified status of the plan, the employer must pay a user fee. The user fee may range from \$125 to \$1,250, depending upon the scope of the request and the type and format of the plan.⁸⁹

Description of Proposal

A small employer (100 or fewer employees) would not be required to pay a user fee for any determination letter with respect to the qualified status of a retirement plan that the employer maintains. The proposal would apply only to requests by employers for determination letters concerning the qualified retirement plans they maintain. Therefore, a sponsor of a prototype plan would be required to pay a user fee for a request for a notification letter, opinion letter, or similar ruling. A small employer that adopts a prototype plan, however, would not be required to pay a user fee for a determination letter request with respect to the employer’s plan.

Effective Date

The proposal would be effective for determination letter requests made after December 31, 2000.

8. Definition of compensation for purposes of deduction limits

Present Law

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan. Subject to certain

⁸⁸ The limits on deferrals under a section 457 plan would be modified under other provisions of the proposal.

⁸⁹ User fees are statutorily authorized; however, the IRS sets the dollar amount of the fee applicable to any particular type of request.

exceptions, nondeductible contributions are subject to a 10-percent excise tax.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In some cases, the amount of deductible contributions is limited by compensation. In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

In the case of an employee stock ownership plan ("ESOP"), principal payments on a loan used to acquire qualifying employer securities are deductible up to 25 percent of compensation.

For purposes of the deduction limits, employee elective deferral contributions to a qualified cash or deferred arrangement ("section 401(k) plan") are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.⁹⁰

For purposes of the deduction limits, compensation means the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan, and the beneficiaries under a profit-sharing or stock bonus plan are the employees who benefit under the plan with respect to the employer's contribution.⁹¹ An employee who is eligible to make elective deferrals under a section 401(k) plan is treated as benefitting under the arrangement even if the employee elects not to defer.⁹²

For purposes of the deduction rules, compensation generally includes only taxable compensation, and thus does not include salary reduction amounts, such as elective deferrals under a section 401(k) plan or a tax-sheltered annuity ("section 403(b) annuity"), elective contributions under a deferred compensation plan of a tax-exempt organization or a State or local government ("section 457 plan"), and salary reduction contributions under a section 125 cafeteria plan. For

⁹⁰ Another provision in the proposal would provide that elective deferrals are not subject to the deduction limits.

⁹¹ Rev. Rul. 65-295, 1965-2 C.B. 148.

⁹² Treas. Reg. sec. 1.410(b)-3.

purposes of the contribution limits under section 415, compensation does include such salary reduction amounts.

Description of Proposal

Under the proposal, the definition of compensation for purposes of the deduction rules would include salary reduction amounts treated as compensation under section 415.⁹³

Effective Date

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

9. Option to treat elective deferrals as after-tax contributions

Present Law

A qualified cash or deferred arrangement (“section 401(k) plan”) or a tax-sheltered annuity (“section 403(b) annuity”) may permit a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. Contributions made to the plan at the election of a participant are elective deferrals. Elective deferrals must be nonforfeitable and are subject to an annual dollar limitation (sec. 402(g)) and distribution restrictions. In addition, elective deferrals under a section 401(k) plan are subject to special nondiscrimination rules. Elective deferrals (and earnings attributable thereto) are not includible in a participant’s gross income until distributed from the plan.

Individuals with adjusted gross income below certain levels generally may make nondeductible contributions to a Roth IRA and may convert a deductible or nondeductible IRA into a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the 5-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-1/2, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to \$10,000). A distribution from a Roth IRA that is not a qualified distribution is includible in income to the extent attributable to earnings, and is subject to the 10-percent tax on early withdrawals (unless an exception applies).⁹⁴

⁹³ A technical correction in the proposal would expand the salary reduction amounts treated as compensation to include amounts used to purchase qualified transportation benefits (under sec. 132(f)).

⁹⁴ Early distributions of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the 4-year rule applicable to 1998 conversions.

Description of Proposal

A section 401(k) plan or a section 403(b) annuity would be permitted to include a “qualified plus contribution program” that would permit a participant to elect to have all or a portion of the participant’s elective deferrals under the plan treated as designated plus contributions. Designated plus contributions would be elective deferrals that the participant designates as not excludable from the participant’s gross income.

The annual dollar limitation on a participant’s designated plus contributions would be the section 402(g) annual limitation on elective deferrals, reduced by the participant’s elective deferrals that the participant does not designate as designated plus contributions. Designated plus contributions would be treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions. Under a section 401(k) plan, designated plus contributions also would be treated as any other elective deferral for purposes of the special nondiscrimination requirements.

The plan would be required to establish a separate account, and maintain separate recordkeeping, for a participant’s designated plus contributions (and earnings allocable thereto). A qualified distribution from a participant’s designated plus contributions account would not be includible in the participant’s gross income. A qualified distribution would be a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59-1/2, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant’s being disabled.⁹⁵ The nonexclusion period would be the 5-year-taxable period beginning with the earlier of (1) the first taxable year for which the participant made a designated plus contribution to any designated plus contribution account established for the participant under the plan, or (2) if the participant has made a rollover contribution to the designated plus contribution account that is the source of the distribution from a designated plus contribution account established for the participant under another plan, the first taxable year for which the participant made a designated plus contribution to the previously established account.

A distribution from a designated plus contributions account that is a corrective distribution of an elective deferral (and income allocable thereto) that exceeds the section 402(g) annual limit on elective deferrals would not be a qualified distribution.

A participant would be permitted to roll over a distribution from a designated plus contributions account only to another designated plus contributions account or a Roth IRA of the participant.

The Secretary of the Treasury would be directed to require the plan administrator of each section 401(k) plan or section 403(b) annuity that permits participants to make designated plus

⁹⁵ A qualified special purpose distributions, as defined under the rules relating to Roth IRAs, would not qualify as a tax-free distribution from a designated plus contributions account.

contributions to make such returns and reports regarding designated plus contributions to the Secretary, plan participants and beneficiaries, and other persons that the Secretary may designate.

Effective Date

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

10. Increase minimum benefit under defined benefit plans

Present Law

Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100 percent of the participant's compensation, or (2) \$130,000 (for 1999).⁹⁶ Payment of a minimum annual benefit is permitted even if the benefit exceeds the normally applicable benefit limitations. Thus, the limits on benefits are deemed to be satisfied if the aggregate annual retirement benefit of a participant under all defined benefit pension plans of the employer does not exceed \$10,000 and the participant has not participated in a defined contribution plan of the employer. The \$10,000 limit is reduced for participants with less than 10 years of service with the employer.

Description of Proposal

Beginning in 2001, the minimum annual benefit permitted under a defined benefit plan would increase in \$10,000 annual increments until the minimum benefit amount reaches \$40,000 in 2003. The \$40,000 amount would not be indexed. In addition, a participant would be entitled to the minimum benefit even if the participant had participated in a defined contribution plan of the employer.

Effective Date

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

⁹⁶ Another provision of the proposal would increase the dollar limit on the annual benefit under a defined benefit plan.

B. Enhancing Fairness for Women

1. Additional salary reduction catch-up contributions

Present Law

Elective deferral limitations

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a “401(k) plan”), a tax-sheltered annuity (“section 403(b) annuity”) or a salary reduction simplified employee pension plan (“SEP”) is \$10,000 (for 1999). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is \$6,000. These limits are indexed for inflation in \$500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a “section 457 plan”) is the lesser of (1) \$8,000 (for 1999) or (2) 33-1/3 percent of compensation. The \$8,000 dollar limit is increased for inflation in \$500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant’s last 3 years before retirement, the otherwise applicable limit is increased to the lesser of (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

Description of Proposal

The proposal would provide that the otherwise applicable dollar limit on elective deferrals under a section 401(k) plan, section 403(b) annuity, or SIMPLE, or deferrals under a section 457 plan would be increased for individuals who have attained at least age 50 during the year.⁹⁷ The otherwise applicable dollar limit would be increased by \$1,000 in each year beginning in 2001 until the amount of the increase is \$5,000 in 2005. Thereafter, the \$5,000 limit would be indexed for inflation in \$500 increments. In the case of a section 457 plans, this catch-up rule would not apply during the participant’s last 3 years before retirement (in those years, the regularly applicable dollar limit is doubled).

⁹⁷ Another provision in the proposal would increase the dollar limit on elective deferrals under such arrangements.

Effective Date

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

2. Equitable treatment for contributions of employees to defined contribution plans

Present Law

Present law imposes limits on the contributions that may be made to tax-favored retirement plans.

Defined contribution plans

In the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser of \$30,000 (for 1999) or 25 percent of the employee's compensation (sec. 415(c)). Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions.

Tax-sheltered annuities

In the case of a tax-sheltered annuity (a "section 403(b) annuity"), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit. The exclusion allowance for a year is equal to 20 percent of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or section 457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25 percent of compensation limit under section 415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25 percent of the participant's includible compensation; or (3) \$15,000.

Under a third special rule, the employee may elect to contribute up to the section 415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to section 403(b) annuities, includible compensation means the amount of compensation received from the employer for the most recent period which may be counted as a year of service under the exclusion allowance. In addition, includible compensation includes elective deferrals and similar salary reduction amounts.

Section 457 plans

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or State and local governmental employer (a “section 457 plan”) is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) \$8,000 (in 1999) or (2) 33-1/3 percent of compensation. The \$8,000 limit is increased for inflation in \$500 increments.

Description of Proposal

Increase in defined contribution plan limit

The proposal would increase the 25 percent of compensation limitation on annual additions under a defined contribution plan to 100 percent.⁹⁸

Conforming limits on tax-sheltered annuities

The proposal would repeal the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities would be subject to the limits applicable to tax-qualified plans.

Section 457 plans

The proposal would increase the 33-1/3 percent of compensation limitation on deferrals under a section 457 plan to 100 percent of compensation.

Effective Date

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

3. Faster vesting of employer matching contributions

⁹⁸ Another provision of the proposal would increase the defined contribution plan dollar limit.

Present Law

Under present law, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent after 4 years of service, 60 percent after 5 years of service, 80 percent after 6 years of service, and 100 percent after 7 years of service.⁹⁹

Description of Proposal

The proposal would apply faster vesting schedules to employer matching contributions. Under the proposal, employer matching contributions would have to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan would satisfy the first schedule if a participant acquires a nonforfeitable right to 100 percent of employer matching contributions upon the completion of 3 years of service. A plan would satisfy the second schedule if a participant has a nonforfeitable right to 20 percent of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100 percent after 6 years of service.

Effective Date

The proposal would be effective for years beginning after December 31, 2000, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The provision would not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date would be taken into account.

4. Simplify and update the minimum distribution rules

Present Law

In general

Minimum distribution rules apply to all types of tax-favored retirement vehicles, including qualified plans, individual retirement arrangements ("IRAs"), tax-sheltered annuities ("section 403(b) annuities"), and eligible deferred compensation plans of tax-exempt and State and local government employers ("section 457 plans"). In general, under these rules, distribution of

⁹⁹ The minimum vesting requirements are also contained in Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the individual plan participant equal to 50 percent of the required minimum distribution not distributed for the year. The excise tax can be waived if the individual establishes to the satisfaction of the Secretary that the shortfall in the amount distributed was due to reasonable error and reasonable steps are being taken to remedy the shortfall.

Distributions prior to the death of the individual

In the case of distributions prior to the death of the plan participant, the minimum distribution rules are satisfied if either (1) the participant's entire interest in the plan is distributed by the required beginning date, or (2) the participant's interest in the plan is to be distributed (in accordance with regulations), beginning not later than the required beginning date, over a permissible period. The permissible periods are (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) the life expectancy of the participant, or (4) the joint life and last survivor expectancy of the participant and a designated beneficiary. In calculating minimum required distributions, life expectancies of the participant and the participant's spouse may be recomputed annually.

In the case of qualified plans, tax-sheltered annuities, and section 457 plans, the required beginning date is the April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2 or (2) the calendar year in which the employee retires. However, in the case of a 5-percent owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70-1/2. If commencement of benefits is delayed beyond age 70-1/2 from a defined benefit plan, then the accrued benefit of the employee must be actuarially increased to take into account the period after age 70-1/2 in which the employee was not receiving benefits under the plan.¹⁰⁰ In the case of distributions from an IRA other than a Roth IRA, the required beginning date is the April 1 following the calendar year in which the IRA owner attains age 70-1/2. The pre-death minimum distribution rules do not apply to Roth IRAs.

In general, under proposed regulations, in order to satisfy the minimum distribution rules, annuity payments under a defined benefit plan must be paid in period payments made at intervals not longer than one year over a permissible period, and must be nonincreasing, or increase only as a result of the following: (1) cost-of-living adjustments; (2) cash refunds of employee contributions; (3) benefit increases under the plan; or (4) an adjustment due to death of the employee's beneficiary. In the case of a defined contribution plan, the minimum required distribution is determined by dividing the employee's benefit by the applicable life expectancy.

Distributions after the death of the plan participant

¹⁰⁰ State and local government plans and church plans are not required to actuarially increase benefits that begin after age 70-1/2.

The minimum distribution rules also apply to distributions to beneficiaries of deceased participants. In general, if the participant dies after minimum distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If the participant dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within 5 years of the participant's death. The 5-year rule does not apply if distributions begin within 1 year of the participant's death and are payable over the life of a designated beneficiary or over the life expectancy of a designated beneficiary. A surviving spouse beneficiary is not required to begin distribution until the date the deceased participant would have attained age 70-1/2.

Special rules for section 457 plans

Eligible deferred compensation plans of State and local and tax-exempt employers ("section 457 plans") are subject to the minimum distribution rules described above. Such plans are also subject to additional minimum distribution requirements (sec. 457(d)(2)(b)).

Description of Proposal

Modification of post-death distribution rules

The proposal would apply the present-law rules applicable if the participant dies before distribution of minimum benefits has begun to all post-death distributions. Thus, in general, if the employee dies before his or her entire interest has been distributed, distribution of the remaining interest must be made within 5 years of the date of death, or begin within one year of the date of death and paid over the life or life expectancy of a designated beneficiary. In the case of a surviving spouse, distributions would not be required to begin until the surviving spouse attains age 70-1/2. Minimum distributions that have already begun could be recalculated under the new rule.

Reduction in excise tax

The proposal would reduce the excise tax on failures to satisfy the minimum distribution rules to 10 percent of the amount that was required to be distributed but was not distributed.

Treasury regulations

The Treasury would be directed to update, simplify and finalize the regulations relating to the minimum distribution rules. The Treasury would be directed to reflect in the regulations current life expectancies and to revise the required distribution methods so that, under reasonable assumptions, the amount of the required distribution does not decrease over time. The regulations are to permit recalculation of distributions for future years to reflect the change in the regulations, and to permit the election of a new designated beneficiary and method of calculating life expectancy. The regulations are to be effective for years beginning after December 31, 2000.

Section 457 plans

The proposal would repeal the special minimum distribution rules applicable to section 457 plans. Thus, such plans would be subject to the same minimum distribution rules applicable to other types of tax-favored arrangements.

Effective Date

In general, the proposal would be effective for years beginning after December 31, 2000.

5. Clarification of tax treatment of division of section 457 plan benefits upon divorce

Present Law

Under present law, benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances. One exception to the prohibition on assignment or alienation rule is a qualified domestic relations order (“QDRO”). A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant, and that meets certain procedural requirements.

Under present law, amounts distributed from a qualified plan generally are taxable to the participant in the year of distribution. However, if amounts are distributed to the spouse (or former spouse) of the participant by reason of a QDRO, the benefits are taxable to the spouse (or former spouse). Amounts distributed pursuant to a QDRO to an alternate payee other than the spouse (or former spouse) are taxable to the plan participant.

Section 457 of the Internal Revenue Code provides rules for deferral of compensation by an individual participating in an eligible deferred compensation plan (“section 457 plan”) of a tax-exempt or State and local government employer. The QDRO rules do not apply to section 457 plans.

Description of Proposal

The proposal would apply the taxation rules for qualified plan distributions pursuant to a QDRO to distributions made pursuant to a domestic relations order from a section 457 plan. In addition, a section 457 plan would not be treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO.

Effective Date

The proposal would be effective for transfers, distributions and payments made after December 31, 2000.

C. Increasing Portability for Participants

1. Rollovers of retirement plan and IRA distributions

Present Law

In general

Present law permits the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that apply depend on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that are not rolled over depend on the type of plan involved.

Distributions from qualified plans

Under present law, an “eligible rollover distribution” from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement (“IRA”)¹⁰¹ or another qualified plan.¹⁰² An “eligible rollover distribution” means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except the term does not include (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee’s designated beneficiary, or (b) for a specified period of 10 years or more, (2) any distribution to the extent such distribution is required under the minimum distribution rules, and (3) certain hardship distributions. The maximum amount that can be rolled over is the amount of the distribution includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

Distributions from tax-sheltered annuities

Eligible rollover distributions from a tax-sheltered annuity (“section 403(b) annuity”) may be rolled over into an IRA or another section 403(b) annuity. Distributions from a section 403(b) annuity cannot be rolled over into a tax-qualified plan. Section 403(b) annuities are not required to accept rollovers.

¹⁰¹ A “traditional” IRA refers to IRAs other than Roth IRAs or SIMPLE IRAs. All references to IRAs refers only to traditional IRAs.

¹⁰² An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or, as described below, directly rolled over by the distributing plan.

IRA distributions

Distributions from a traditional IRA, other than minimum required distributions, can be rolled over into another IRA. In general, distributions from an IRA cannot be rolled over into a qualified plan or section 403(b) annuity. An exception to this rule applies in the case of so-called “conduit IRAs.” Under the conduit IRA rule, amounts can be rolled from a qualified plan into an IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from a qualified plan. Similarly, an amount may be rolled over from a section 403(b) annuity to an IRA and subsequently rolled back into a section 403(b) annuity if the amounts in the IRA are attributable solely to rollovers from a section 403(b) annuity.

Distributions from section 457 plans

A “section 457 plan” is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers. For example, governmental section 457 plans are like qualified plans in that plan assets are required to be held in a trust for the exclusive benefit of plan participants and beneficiaries. In contrast, benefits under a section 457 plan of a tax-exempt employer are unfunded, like nonqualified deferred compensation plans of private employers.

Section 457 benefits can be transferred to another section 457 plan. Distributions from a section 457 plan cannot be rolled over to another section 457 plan, a qualified plan, a section 403(b) annuity, or an IRA.

Rollovers by surviving spouses

A surviving spouse that receives an eligible rollover distribution may roll over the distribution into an IRA, but not a qualified plan or section 403(b) annuity.

Direct rollovers and withholding requirements

Qualified plans and section 403(b) annuities are required to provide that a plan participant has the right to elect that an eligible rollover distribution be directly rolled over to another eligible retirement plan. If the plan participant does not elect the direct rollover option, then withholding is required on the distribution at a 20-percent rate.

Notice of eligible rollover distribution

The plan administrator of a qualified plan or a section 403(b) annuity is required to provide a written explanation of rollover rules to individuals who receive a distribution eligible for rollover. In general, the notice is to be provided within a reasonable period of time before making the distribution and is to include an explanation of (1) the provisions under which the individual may have the distribution directly rolled over to another eligible retirement plan, (2) the provision

that requires withholding if the distribution is not directly rolled over, (3) the provision under which the distribution may be rolled over within 60 days of receipt, and (4) if applicable, certain other rules that may apply to the distribution. The Treasury Department has provided more specific guidance regarding timing and content of the notice.

Taxation of distributions

As is the case with the rollover rules, different rules regarding taxation of benefits apply to different types of tax-favored arrangements. In general, distributions from a qualified plan, section 403(b) annuity, or IRA are includible in income in the year received. In certain cases, distributions from qualified plans are eligible for capital gains treatment and averaging. These rules do not apply to distributions from another type of plan. Distributions from a qualified plan, IRA, and section 403(b) annuity generally are subject to an additional 10-percent early withdrawal tax if made before age 59-1/2. There are a number of exceptions to the early withdrawal tax. Some of the exceptions apply to all three types of plans, and others apply only to certain types of plans. For example, the 10-percent early withdrawal tax does not apply to IRA distributions for educational expenses, but does apply to similar distributions from qualified plans and section 403(b) annuities. Benefits under a section 457 plan are generally includible in income when paid or made available. The 10-percent early withdrawal tax does not apply to section 457 plans.

Description of Proposal

In general

The proposal would provide that eligible rollover distributions from qualified retirement plans, section 403(b) annuities, and governmental section 457 plans generally could be rolled over to any of such plans or arrangements.¹⁰³ Similarly, distributions from an IRA generally could be rolled over into a qualified plan, section 403(b) annuity, or governmental section 457 plan. The direct rollover and withholding rules would be extended to distributions from a section 457 plan, and such plans would be required to provide the written notification regarding eligible rollover distributions. The rollover notice (with respect to all plans) would be required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to distributions from the distributing plan. Qualified plans, section 403(b) annuities, and section 457 plans would not be required to accept rollovers.

Some special rules would apply in certain cases. A distribution from a qualified plan would not be eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under present law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over, the rollover would have to be made to a “conduit IRA” as under present law, and then rolled back into a qualified plan.

¹⁰³ Hardship distributions from governmental section 457 plans would be considered eligible rollover distributions.

Amounts distributed from a section 457 plan would be subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Section 457 plans would be required to separately account for such amounts.

The proposal would also provide that benefits in governmental section 457 plans are includible in income when paid.

Rollover of after-tax contributions

The proposal would provide that employee after-tax contributions could be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover could be accomplished only through a direct rollover. In addition, a qualified plan could not accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions (including nondeductible contributions to an IRA) could not be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or section 457 plan.

In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution would be attributed first to amounts other than after-tax contributions.

Expansion of spousal rollovers

The proposal would provide that surviving spouses could roll over distributions to a qualified plan, section 403(b) annuity, or governmental section 457 plan in which the spouse participates.

Treasury regulations

The Secretary would be directed to prescribe rules necessary to carry out the provisions. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS will develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, expand Form 8606 - Nondeductible IRAs, to include information regarding after-tax contributions.

Effective Date

The proposal would be effective for distributions made after December 31, 2000.

2. Waiver of 60-day rule

Present Law

Under present law, amounts received from an IRA or qualified plan may be rolled over tax free if the rollover is made within 60 days of the date of the distribution. The Secretary does not have the authority to waive the 60-day requirement.

Description of Proposal

The proposal would provide that the Secretary may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.

Effective Date

The proposal would apply to distributions made after December 31, 2000.

3. Treatment of forms of distribution

Present Law

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. An amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit (sec. 411(d)(6)).¹⁰⁴

The prohibition against the elimination of an optional form of benefit applies to plan mergers, spinoffs, transfers, and transactions amending or having the effect of amending a plan or plans to transfer plan benefits. For example, if Plan A, a profit-sharing plan that provides for distribution of benefits in annual installments over ten or twenty years, is merged with Plan B, a profit-sharing plan that provides for distribution of benefits in annual installments over life expectancy at the time of retirement, the merged plan must preserve the ten- or twenty-year installment option with respect to benefits accrued under Plan A as of the date of the merger and the installments over life expectancy with respect to benefits accrued under Plan B as of the date of the merger. Similarly, for example, if a participant's benefit under a defined contribution plan is transferred to another defined contribution plan maintained by the same or a different employer, the optional forms of benefit available with respect to the participant's accrued benefit under the transferor plan must be preserved.¹⁰⁵

Description of Proposal

¹⁰⁴ A similar provision is contained in Title I of ERISA.

¹⁰⁵ Treas. Reg. sec. 1.411(d)-4, Q&A-2(a)(3)(i).

A defined contribution plan to which benefits are transferred would not be treated as reducing a participant's or beneficiary's accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if (1) the plan receives from another defined contribution plan a direct transfer of the participant's or beneficiary's benefit accrued under the transferor plan, or the plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employers within a multiple employer plan), (2) the terms of both the transferor plan and the transferee plan authorize the transfer, (3) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary received a notice describing the consequences of making the election, (4) if the transferor plan provides for an annuity as the normal form of distribution in accordance with the joint and survivor annuity rules (sec. 417), the participant's spouse (if any) consents to the transfer in a manner similar to the consent required by section 417, and (5) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a single sum distribution.

In addition, except to the extent provided by the Secretary of the Treasury in regulations, a defined contribution plan would not be treated as reducing a participant's accrued benefit if (1) a plan amendment eliminates a form of distribution previously available under the plan, (2) a single sum distribution is available to the participant at the same time or times as the form of distribution eliminated by the amendment, and (3) the single sum distribution is based on the same or greater portion of the participant's accrued benefit as the form of distribution eliminated by the amendment.

The Secretary would be directed to issue, not later than December 31, 2001, final regulations under section 411(d)(6) implementing the provisions of the proposal.

Furthermore, the proposal would authorize the Secretary of the Treasury to provide by regulations that the prohibitions against eliminating or reducing an early retirement benefit, a retirement-type subsidy, or an optional form of benefit would not apply to plan amendments that do not adversely affect the rights of participants in a material manner but that do eliminate or reduce early retirement benefits, retirement-type subsidies, and optional forms of benefit that create significant burdens and complexities for a plan and its participants.

It would be intended that the factors to be considered in determining whether an amendment has a materially adverse effect on a participant would include (1) all of the participant's early retirement benefits, retirement-type subsidies, and optional forms of benefits that are reduced or eliminated by the amendment, (2) the extent to which early retirement benefits, retirement-type subsidies, and optional forms of benefit in effect with respect to a participant after the amendment effective date provide rights that are comparable to the rights that are reduced or eliminated by the plan amendment, (3) the number of years before the participant attains normal retirement age under the plan (or early retirement age, as applicable), (4) the size of the participant's benefit that is affected by the plan amendment, in relation to the amount of the participant's compensation, and (5) the number of years before the plan amendment is effective.

Effective Date

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

4. Rationalization of restrictions on distributions

Present Law

Elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”), tax-sheltered annuity (“section 403(b) annuity”), or an eligible deferred compensation plan of a tax-exempt organization or State or local government (“section 457 plan”), may not be distributable prior to the occurrence of one or more specified events. These permissible distributable events include “separation from service.”

A separation from service occurs only upon a participant’s death, retirement, resignation or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, consolidation or other similar corporate transaction. A severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under a so-called “same desk rule,” a participant’s severance from employment does not necessarily result in a separation from service.¹⁰⁶

In addition to separation from service and other events, a section 401(k) plan that is maintained by a corporation may permit distributions to certain employees who experience a severance from employment with the corporation that maintains the plan but does not experience a separation from service because the employee continues on the same job for a different employer as a result of a corporate transaction. If the corporation disposes of substantially all of the assets used by the corporation in a trade or business, a distributable event occurs with respect to the accounts of the employees who continue employment with the corporation that acquires the assets. If the corporation disposes of its interest in a subsidiary, a distributable event occurs with respect to the accounts of the employees who continue employment with the subsidiary.

Description of Proposal

The proposal would modify the distribution restrictions applicable to section 401(k) plans, section 403(b) annuities, and section 457 plans to provide that distribution may occur upon severance from employment rather than separation from service. In addition, the provisions for distribution from a section 401(k) plan based upon a corporation’s disposition of its assets or a subsidiary would be repealed; this special rule would no longer be necessary under the proposal.

Effective Date

The proposal would be effective for distributions after December 31, 2000.

5. Purchase of service credit under governmental pension plans

¹⁰⁶ Rev. Rul. 79-336, 1979-2 C.B. 187.

Present Law

A qualified retirement plan maintained by a State or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits (sec. 415). Permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) that does not exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

In the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits.

A participant may not use a rollover or direct transfer of benefits from a tax-sheltered annuity ("section 403(b) annuity") or an eligible deferred compensation plan of a tax-exempt organization of a State or local government ("section 457 plan") to purchase permissive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

Description of Proposal

A participant in a State or local governmental plan would not be required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a section 457 plan if the transferred amount is used (1) to purchase permissive service credits under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State).

Effective Date

The proposal would be effective for transfers after December 31, 2000.

6. Employers may disregard rollovers for purposes of cash-out rules

Present Law

If an qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed \$5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in

computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.¹⁰⁷

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan.¹⁰⁸

Description of Proposal

A plan would be permitted to provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of such benefit that is attributable to rollover contributions (and any earnings allocable thereto).

Effective Date

The proposal would be effective for distributions after December 31, 2000.

¹⁰⁷ A similar provision is contained in Title I of ERISA.

¹⁰⁸ Other provisions of the proposal would expand the kinds of plans to which benefits may be rolled over.

D. Strengthening Pension Security And Enforcement

1. Phase in repeal of 150 percent of current liability funding limit; deduction for contributions to fund termination liability

Present Law

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 155 percent of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)).¹⁰⁹ In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 160 percent for plan years beginning in 2001 or 2002, 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.¹¹⁰ In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.

Description of Proposal

Current liability full funding limit

The proposal would gradually increase and then repeal the current liability full funding limit. The current liability full funding limit would be 160 percent of current liability for plan years beginning in 2001, 165 percent for plan years beginning in 2002, and 170 percent for plan years

¹⁰⁹ The minimum funding requirements, including the full funding limit, are also contained in title I of ERISA.

¹¹⁰ As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, and adopted the scheduled increases described in the text.

beginning in 2003. The current liability full funding limit would be repealed for plan years beginning in 2004 and thereafter.

Deduction for contributions to fund termination liability

Under the proposal, the special rule allowing a deduction for unfunded current liability generally would be extended to all defined benefit pension plans, i.e., the provision would apply to multiemployer plans and plans with 100 or fewer participants. The special rule would not apply to plans not covered by the PBGC termination insurance program.¹¹¹

The proposal would also modify the rule by providing that the deduction is for up to 100 percent of unfunded termination liability, determined as if the plan terminated at the end of the plan year. In the case of a plan with less than 100 participants for the plan year, termination liability would not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment which was made or became effective, whichever is later, within the last two years.

Effective Date

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

2. Extension of PBGC missing participants program

Present Law

The plan administrator of a defined benefit pension plan that is subject to Title IV of ERISA, is maintained by a single employer, and terminates under a standard termination is required to distribute the assets of the plan. With respect to a participant whom the plan administrator cannot locate after a diligent search, the plan administrator satisfies the distribution requirement only by purchasing irrevocable commitments from an insurer to provide all benefit liabilities under the plan or transferring the participant's designated benefit to the Pension Benefit Guaranty Corporation ("PBGC"), which holds the benefit of the missing participant as trustee until the PBGC locates the missing participant and distributes the benefit.

The PBGC missing participant program is not available to multiemployer plans or defined contribution plans and other plans not covered by Title IV of ERISA.

Description of Proposal

The proposal would direct the PBGC to prescribe for terminating multiemployer plans rules

¹¹¹ The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

similar to the present-law missing participant rules applicable to terminating single employer plans that are subject to Title IV of ERISA.

In addition, to the extent provided in PBGC regulations, plan administrators of certain types of plans that are not covered by the PBGC missing participant program under present law would be permitted, but not required, to elect to transfer missing participants' benefits to the PBGC upon plan termination. Specifically, the proposal would extend the missing participants program to defined contribution plans, defined benefit plans that do not have more than 25 active participants and are maintained by professional service employers, and the portions of defined benefit plans that provide benefits based upon the separate accounts of participants and therefore are treated as defined contribution plans under ERISA.

Effective Date

The proposal would be effective for distributions from terminating plans that occur after the PBGC has adopted final regulations implementing the proposal.

3. Excise tax relief for sound pension funding

Present Law

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 155 percent of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)). In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 160 percent for plan years beginning in 2001 or 2002, 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.¹¹² In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a

¹¹² As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, and adopted the scheduled increases described in the text.

defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.

Present law also provides that contributions to defined contribution plans are deductible, subject to certain limitations.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year. The 10-percent excise tax does not apply to contributions to certain terminating defined benefit plans. The 10-percent excise tax also does not apply to contributions of up to 6 percent of compensation to a defined contribution plan for employer matching and employee elective deferrals.

Description of Proposal

Under the proposal, in determining the amount of nondeductible contributions, the employer could elect not to take into account contributions to a defined benefit pension plan except to the extent they exceed the accrued liability full funding limit. Thus, if an employer elects, contributions in excess of the current liability full funding limit would not be subject to the excise tax on nondeductible contributions. An employer making such an election for a year could not take advantage of the present-law exceptions for certain terminating plans and certain contributions to defined contribution plans.

Effective Date

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

4. Notice of significant reduction in plan benefit accruals

Present Law

Section 204(h) of Title I of ERISA provides that a defined benefit pension plan or a money purchase pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual, unless, after adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment, the plan administrator provides a written notice ("section 204(h) notice"), setting forth the plan amendment (or a summary of the amendment written in a manner calculated to be understood by the average plan participant) and its effective date. The plan administrator must provide the section 204(h) notice to each plan participant, each alternate payee under an applicable qualified domestic relations order ("QDRO"), and each employee organization representing participants in the plan. The applicable Treasury regulations¹¹³ provide, however, that

¹¹³ Treas. Reg. sec. 1.411(d)-6.

a plan administrator need not provide the section 204(h) notice to any participant or alternate payee whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment, nor to an employee organization that does not represent a participant to whom the section 204(h) notice must be provided. In addition, the regulations provide that the rate of future benefit accrual is determined without regard to optional forms of benefit, early retirement benefits, retirement-type subsidiaries, ancillary benefits, and certain other rights and features.

A covered amendment generally will not become effective with respect to any participants and alternate payees whose rate of future benefit accrual is reasonably expected to be reduced by the amendment but who do not receive a section 204(h) notice. An amendment will become effective with respect to all participants and alternate payees to whom the section 204(h) notice was required to be provided if the plan administrator (1) has made a good faith effort to comply with the section 204(h) notice requirements, (2) has provided a section 204(h) notice to each employee organization that represents any participant to whom a section 204(h) notice was required to be provided, (3) has failed to provide a section 204(h) notice to no more than a de minimis percentage of participants and alternate payees to whom a section 204(h) notice was required to be provided, and (4) promptly upon discovering the oversight, provides a section 204(h) notice to each omitted participant and alternate payee.

The Internal Revenue Code does not require any notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual.

Description of Proposal

The proposal would add to the Internal Revenue Code a requirement that the plan administrator of a defined benefit pension plan or a money purchase pension plan with more than 100 participants furnish a written notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual. The plan administrator would be required to provide in this notice, in a manner calculated to be understood by the average plan participant, sufficient information (as defined in Treasury regulations) to allow participants to understand the effect of the amendment.

The plan administrator would be required to provide this notice to each affected participant, each affected alternate payee, and each employee organization representing affected participants. For purposes of the proposal, an affected participant or alternate payee would be a participant or alternate payee to whom the significant reduction in the rate of future benefit accrual would be reasonably expected to apply.

Except to the extent provided by Treasury regulations, the plan administrator would be required to provide the notice within a reasonable time before the effective date of the plan amendment.

The proposal would impose on a plan administrator that fails to comply with the notice requirement an excise tax equal to \$100 per day per omitted participant and alternate payee. For failures due to reasonable cause and not to willful neglect, the total excise tax imposed during a

taxable year of the employer would not exceed \$500,000. Furthermore, in the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury would be authorized to waive the excise tax to the extent that the payment of the tax would be excessive relative to the failure involved.

Effective Date

The proposal would be effective for plan amendments taking effect on or after the date of enactment. The period for providing any notice required under the proposal would not end before the last day of the 3-month period following the date of enactment. Prior to the issuance of Treasury regulations, a plan would be treated as meeting the requirements of the proposal if the plan makes a good faith effort to comply with such requirements.

E. Reducing Regulatory Burdens

1. Repeal of the multiple use test

Present Law

Elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”) are subject to a special annual nondiscrimination test (“ADP test”). The ADP test compares the actual deferral percentages (“ADPs”) of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee’s deferral percentage generally is the employee’s elective deferrals for the year divided by the employee’s compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ADP of the nonhighly compensated employee group for the prior plan year and not more than 2 percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Employer matching contributions and after-tax employee contributions under a defined contribution plan also are subject to a special annual nondiscrimination test (“ACP test”). The ACP test compares the actual deferral percentages (“ACPs”) of the highly compensated employee group and the nonhighly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are eligible to make after-tax employee contributions or who are eligible for an allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee’s contribution percentage generally is the employee’s aggregate after-tax employee contributions and matching contributions for the year divided by the employee’s compensation for the year.

The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the nonhighly compensated employee group for the prior plan year and not more than 2 percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

For any year in which (1) at least one highly compensated employee is eligible to participate in an employer’s plan or plans that are subject to both the ADP test and the ACP test, (2) the plan subject to the ADP test satisfies the ADP test but the ADP of the highly compensated employee group exceeds 125 percent of the ADP of the nonhighly compensated employee group, and (3) the plan subject to the ACP test satisfies the ACP test but the ACP of the highly

compensated employee group exceeds 125 percent of the ACP of the nonhighly compensated employee group, an additional special nondiscrimination test (“Multiple Use test”) applies to the elective deferrals, employer matching contributions, and after-tax employee contributions. The plan or plans generally satisfy the Multiple Use test if the sum of the ADP and the ACP of the highly compensated employee group does not exceed the greater of (1) the sum of (A) 1.25 times the greater of the ADP or the ACP of the nonhighly compensated employee group, and (B) 2 percentage points plus (but not more than 2 times) the lesser of the ADP or the ACP of the nonhighly compensated employee group, or (2) the sum of (A) 1.25 times the lesser of the ADP or the ACP of the nonhighly compensated employee group, and (B) 2 percentage points plus (but not more than 2 times) the greater of the ADP or the ACP of the nonhighly compensated employee group.

Description of Proposal

The proposal would repeal the Multiple Use test.

Effective Date

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

2. Flexibility in nondiscrimination and line of business rules

Present Law

A plan is not a qualified retirement plan if the contributions or benefits provided under the plan discriminate in favor of highly compensated employees (sec. 401(a)(4)). The applicable Treasury regulations set forth the exclusive rules for determining whether a plan satisfies the nondiscrimination requirement. These regulations state that the form of the plan and the effect of the plan in operation determine whether the plan is nondiscriminatory and that intent is irrelevant.

Similarly, a plan is not a qualified retirement plan if the plan does not benefit a minimum number of employees (sec. 410(b)). A plan satisfies this minimum coverage requirement if and only if it satisfies one of the tests specified in the applicable Treasury regulations. If an employer is treated as operating separate lines of business, the employer may apply the minimum coverage requirements to a plan separately with respect to the employees in each separate line of business (sec. 414(r)). Under a so-called “gateway” requirement, however, the plan must benefit a classification of employees that does not discriminate in favor of highly compensated employees in order for the employer to apply the minimum coverage requirements separately for the employees in each separate line of business. A plan satisfies this gateway requirement only if it satisfies one of the tests specified in the applicable Treasury regulations.

Description of Proposal

The Secretary of the Treasury would be directed to modify, on or before December 31, 2000, the existing regulations issued under section 401(a)(4) and section 414(r) in order to expand

(to the extent that the Secretary may determine to be appropriate) the ability of a plan to demonstrate compliance with the nondiscrimination and line of business requirements based upon the facts and circumstances surrounding the design and operation of the plan, even though the plan is unable to satisfy the mechanical tests currently used to determine compliance.

Effective Date

The proposal would be effective on the date of enactment.

3. Modification of timing of plan valuations

Present Law

Under present law, in the case of plans subject to the minimum funding rules, a plan valuation is generally required annually. The Secretary may require that a valuation be made more frequently in particular cases.

Prior to the Retirement Protection Act of 1994, plan valuations generally were required at least once every three years.

Description of Proposal

The proposal would allow an employer to elect to use the prior year's plan valuation in certain cases. The election could be made only with respect to a defined benefit plan with assets of at least 125 percent of current liability (determined as of the valuation date for the preceding year). If the prior year's valuation is used, it would have to be adjusted, as provided in regulations, to reflect significant differences in participants. An election made under the proposal could be revoked only with the consent of the Secretary. In any event, a plan valuation would be required once every three years.¹¹⁴

Effective Date

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

4. Rules for substantial owner benefits in terminated plans

Present Law

Under present law, the Pension Benefit Guaranty Corporation ("PBGC") provides participants and beneficiaries in a defined benefit pension plan with certain minimal guarantees as to the receipt of benefits under the plan in case of plan termination. The employer sponsoring the

¹¹⁴ As under present law, the Secretary could require that a valuation be made more frequently in particular cases.

defined benefit pension plan is required to pay premiums to the PBGC to provide insurance for the guaranteed benefits. In general, the PBGC will guarantee all basic benefits which are payable in periodic installments for the life (or lives) of the participant and his or her beneficiaries and are non-forfeitable at the time of plan termination. The amount of the guaranteed benefit is subject to certain limitations. One limitation is that the plan (or an amendment to the plan which increases benefits) must be in effect for 60 months before termination for the PBGC to guarantee the full amount of basic benefits for a plan participant, other than a substantial owner. In the case of a substantial owner, the guaranteed basic benefit is phased in over 30 years beginning with participation in the plan. A substantial owner is one who owns, directly or indirectly, more than 10 percent of the voting stock of a corporation or all the stock of a corporation. Special rules restricting the amount of benefit guaranteed and the allocation of assets also apply to substantial owners.

Description of Proposal

The proposal would provide that the 60 month phase-in of guaranteed benefits would apply to a substantial owner with less than 50 percent ownership interest. For a substantial owner with a 50 percent or more ownership interest (“majority owner”), the phase-in would depend on the number of years the plan has been in effect. The majority owner’s guaranteed benefit would be limited so that it could not be more than the amount phased in over 60 months for other participants. The rules regarding allocation of assets would apply to substantial owners, other than majority owners, in the same manner as other participants.

Effective Date

The proposal would be effective for plan terminations with respect to which notices of intent to terminate are provided, or for which proceedings for termination are instituted by the PBGC after December 31, 2000.

5. ESOP dividends may be reinvested without loss of dividend deduction

Present Law

An employer is entitled to deduct certain dividends paid in cash during the employer’s taxable year with respect to stock of the employer that is held by an employee stock ownership plan (“ESOP”). The deduction is allowed with respect to dividends that, in accordance with plan provisions, are (1) paid in cash directly to the plan participants or their beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) used to make payments on loans (including payments of interest as well as principal) that were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

Description of Proposal

In addition to the deductions permitted under present law for dividends paid with respect to employer securities that are held by an ESOP, an employer would be entitled to deduct dividends that, at the election of plan participants or their beneficiaries, are (1) payable in cash directly to plan participants or beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) paid to the plan and reinvested in qualifying employer securities.

Effective Date

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

6. Notice and consent period regarding distributions

Present Law

Notice and consent requirements apply to certain distributions from qualified retirement plans. These requirements relate to the content and timing of information that a plan must provide to a participant prior to a distribution, and to whether the plan must obtain the participant's consent to the distribution. The nature and extent of the notice and consent requirements applicable to a distribution depend upon the value of the participant's vested accrued benefit and whether the joint and survivor annuity requirements (sec. 417) apply to the participant.¹¹⁵

If the present value of the participant's vested accrued benefit exceeds \$5,000, the plan may not distribute the participant's benefit without the written consent of the participant. The participant's consent to a distribution is not valid unless the participant has received from the plan a notice that contains a written explanation of (1) the material features and the relative values of the optional forms of benefit available under the plan, (2) the participant's right, if any, to have the distribution directly transferred to another retirement plan or IRA, and (3) the rules concerning the taxation of a distribution. If the joint and survivor annuity requirements apply to the participant, this notice also must contain a written explanation of (1) the terms and conditions of the qualified joint and survivor annuity ("QJSA"), (2) the participant's right to make, and the effect of, an election to waive the QJSA, (3) the rights of the participant's spouse with respect to a participant's waiver of the QJSA, and (4) the right to make, and the effect of, a revocation of a waiver of the QJSA. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.

If the participant's vested accrued benefit does not exceed \$5,000, the terms of the plan may provide for distribution without the participant's consent. The plan generally is required, however, to provide to the participant a notice that contains a written explanation of (1) the participant's right, if any, to have the distribution directly transferred to another retirement plan or IRA, and (2) the rules concerning the taxation of a distribution. The plan generally must provide this notice to

¹¹⁵ Similar provisions are contained in Title I of ERISA.

the participant no less than 30 and no more than 90 days before the date distribution commences.

Description of Proposal

A qualified retirement plan would be required to provide the applicable distribution notice no less than 30 days and no more than six months before the date distribution commences. The Secretary of the Treasury would be directed to modify the applicable regulations to reflect the extension of the notice period to six months and to provide that the description of a participant's right, if any, to defer receipt of a distribution shall also describe the consequences of failing to defer such receipt.

Effective Date

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

7. Repeal transition rule relating to certain highly compensated employees

Present Law

Under present law, for purposes of the rules relating to qualified plans, a highly compensated employee is generally defined as an employee¹¹⁶ who (1) was a 5-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of \$80,000 (for 1999) or (b) at the election of the employer, had compensation in excess of \$80,000 for the preceding year and was in the top 20 percent of employees by compensation for such year.

Under a rule enacted in the Tax Reform Act of 1986, a special definition of highly compensated employee applies for purposes of the nondiscrimination rules relating to qualified cash or deferred arrangements ("section 401(k) plans") and matching contributions. This special definition applies to an employer incorporated on December 15, 1924, that meets certain specific requirements.

Description of Proposal

The proposal would repeal the special definition of highly compensated employee under the Tax Reform Act of 1986. Thus, the present-law definition would apply.

Effective Date

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

¹¹⁶ An employee includes a self-employed individual.

8. Employees of tax-exempt entities

Present Law

The Tax Reform Act of 1986 provided that nongovernmental tax-exempt employers were not permitted to maintain a qualified cash or deferred arrangement (“section 401(k) plan”). This prohibition was repealed, effective for years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996.

Treasury regulations provide that, for purposes of nondiscrimination testing under section 410(b), a section 401(k) plan or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan, the employer may treat as excludable those employees of a tax-exempt entity who could not participate in the arrangement due to the prohibition on maintenance of a section 401(k) plan by such entities. Such employees could be disregarded only if more than 95 percent of the employees who could participate in the section 401(k) plan benefit under the plan for the plan year.¹¹⁷

Tax-exempt charitable organizations may maintain a tax-sheltered annuity (a “section 403(b) annuity”) that allows employees to make salary reduction contributions.

Description of Proposal

The proposal would direct the Treasury Department to revise its regulations under section 410(b) to provide that employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a section 403(b) annuity may be treated as excludable employees for purposes of testing a section 401(k) plan, or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan of the employer if (1) no employee of such tax-exempt entity is eligible to participate in the section 401(k) or 401(m) plan and (2) more than 95 percent of the employees who are not employees of the charitable employer are eligible to participate in such section 401(k) plan or section 401(m) plan.

The revised regulations are to be effective for years beginning after December 31, 1996.

Effective Date

The proposal would be effective on the date of enactment.

9. Treatment of employer-provided retirement advice

Present Law

Under present law, certain employer-provided fringe benefits are excludable from gross

¹¹⁷ Treas. Reg. sec. 1.410(b)-6(g).

income (sec. 132) and wages for employment tax purposes. These excludable fringe benefits include working condition fringe benefits and de minimis fringes. In general, a working condition fringe benefit is any property or services provided by an employer to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction as a business expense. A de minimis fringe benefit is any property or services provided by the employer the value of which, after taking into account the frequency with which similar fringes are provided, is so small as to make accounting for it unreasonable or administratively impracticable.

In addition, if certain requirements are satisfied, up to \$5,250 annually of employer-provided educational assistance is excludable from gross income (sec. 127) and wages. This exclusion expires with respect to courses beginning after May 31, 2000.¹¹⁸ Education not excludable under section 127 may be excludable as a working condition fringe.

There is no specific exclusion under present law for employer-provided retirement planning services. However, such services may be excludable as employer-provided educational assistance or a fringe benefit.

Description of Proposal

The proposal would provide that qualified retirement planning services provided to an employee and his or her spouse are excludable from income and wages. The exclusion would not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's pension plan. The exclusion would not be limited to information regarding the plan but would include, for example, information regarding how the plan relates to retirement income planning as a whole.

Effective Date

The proposal would be effective with respect to taxable years beginning after December 31, 2000.

10. Provisions relating to plan amendments

Present Law

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

Description of Proposal

¹¹⁸ The exclusion does not apply with respect to graduate-level courses.

Any amendments to a plan or annuity contract required to be made by the proposal would not be required to be made before the last day of the first plan year beginning on or after January 1, 2003. In the case of a governmental plan, the date for amendments would be extended to the first plan year beginning on or after January 1, 2005.

Effective Date

The provision would be effective on the date of enactment.

11. Reporting simplification

Present Law

A plan administrator of a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation generally must file with the Secretary of the Treasury an annual return for each plan year containing certain information with respect to the qualification, financial condition, and operation of the plan. Title I of ERISA also may require the plan administrator to file annual reports concerning the plan with the Department of Labor and the Pension Benefit Guaranty Corporation ("PBGC"). The plan administrator must use the Form 5500 series as the format for the required annual return.¹¹⁹ The Form 5500 series annual return/report, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 series annual return/report with the Internal Revenue Service ("IRS"), which forwards the form to the Department of Labor and the PBGC.

The Form 5500 series consists of 3 different forms: Form 5500, Form 5500-C/R, and Form 5500-EZ. Form 5500 is the most comprehensive of the forms and requires the most detailed financial information. Form 5500-C/R requires less information than Form 5500, and Form 5500-EZ, which consists of only 1 page, is the simplest of the forms.

The size of the plan determines which form a plan administrator must file. If the plan has more than 100 participants at the beginning of the plan year, the plan administrator generally must file Form 5500. If the plan has fewer than 100 participants at the beginning of the plan year, the plan administrator generally may file Form 5500-C/R. A plan administrator generally may file Form 5500-EZ if (1) the only participants in the plan are the sole owner of a business that maintains the plan (and such owner's spouse), or partners in a partnership that maintains the plan (and such partners' spouses), (2) the plan is not aggregated with another plan in order to satisfy the minimum coverage requirements of section 410(b), (3) the employer is not a member of a related group of employers, and (4) the employer does not receive the services of leased employees. If the plan satisfies the eligibility requirements for Form 5500-EZ and the total value of the plan assets as of the end of the plan year and all prior plan years does not exceed \$100,000, the plan administrator is not required to file a return.

¹¹⁹ Treas. Reg. sec. 301.6058-1(a).

Description of Proposal

The Secretary of the Treasury would be directed to provide for the filing of a simplified annual return substantially similar to the Form 5500-EZ by a plan that (1) covers less than 25 employees on the first day of the plan year, (2) is not aggregated with another plan in order to satisfy the minimum coverage requirements of section 410(b), (3) is maintained by an employer that is not a member of a related group of employers, and (4) is maintained by an employer that does not receive the services of leased employees.

Effective Date

The proposal would be effective on the date of enactment.

12. Model plans for small businesses

Present Law

The Internal Revenue Service (“IRS”) previously has established uniform plan¹²⁰ and prototype plan¹²¹ programs that were designed, in part, to simplify the preparation of qualified retirement plan documents and the determination letter application process. Neither the IRS nor the Secretary of the Treasury previously have issued model plan documents.

Description of Proposal

The Secretary of the Treasury would be directed to issue, not later than December 31, 2000, at least one model defined contribution plan document and at least one model defined benefit plan document that fit the needs of small businesses and that would be treated as meeting the requirements of section 401(a) with respect to the form of the plan. To the extent that the requirements of section 401(a) are modified after the issuance of the model plans, the Secretary would be directed to issue, in a timely manner, model amendments that, if adopted in a timely manner by an employer that adopts a model plan, would cause the model plan to be treated as meeting the requirements of section 401(a), as modified, with respect to the form of the plan.

Alternatively, the Secretary would be permitted, in its discretion, to enhance and simplify the existing prototype plan programs in a manner that would achieve the purposes of the model plans.

Effective Date

¹²⁰ Rev. Proc. 84-46, 1984-2 C.B. 787.

¹²¹ Rev. Proc. 84-23, 1984-1 C.B. 457; Rev. Proc. 89-9, 1989-1 C.B. 780; Rev. Proc. 89-13, 1989-1 C.B. 801.

The proposal would be effective on the date of enactment.

13. Intermediate sanctions for inadvertent failures

Present Law

A retirement plan that is intended to be a tax-qualified plan provides retirement benefits on a tax-favored basis if the plan satisfies all of the requirements of section 401(a). Similarly, an annuity that is intended to be a tax-sheltered annuity provides retirement benefits on a tax-favored basis if the program satisfies all of the requirements of section 403(b). Failure to satisfy all of the applicable requirements of section 401(a) or section 403(b) may disqualify a plan or annuity for the intended tax-favored treatment.

The Internal Revenue Service (“IRS”) has established the Employee Plans Compliance Resolution System (“EPCRS”), which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended, but have failed, to satisfy the requirements of section 401(a) and section 403(b), as applicable.¹²² EPCRS permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.

The IRS has designed EPCRS to (1) encourage operational and formal compliance, (2) promote voluntary and timely correction of compliance failures, (3) provide sanctions for compliance failures identified on audit that are reasonable in light of the nature, extent, and severity of the violation, (4) provide consistent and uniform administration of the correction programs, and (5) permit employers to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their retirement plans and annuities.

The basic elements of the programs that comprise EPCRS are self-correction, voluntary correction with IRS approval, and correction on audit. The Administrative Policy Regarding Self-Correction (“APRSC”) permits a plan sponsor that has established compliance practices to correct certain insignificant failures at any time (including during an audit), and certain significant failures within a 2-year period, without payment of any fee or sanction. The Voluntary Compliance Resolution (“VCR”) program, the Walk-In Closing Agreement Program (“Walk-In CAP”), and the Tax-Sheltered Annuity Voluntary Correction (“TVC”) program permit an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program (“Audit CAP”) provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

The IRS has expressed its intent that EPCRS will be updated and improved periodically in light of experience and comments from those who use it.

¹²² Rev. Proc. 98-22, 1998-12 I.R.B. 11, as modified by Rev. Proc. 99-13, 1999-5, I.R.B. 52.

Description of Proposal

The Secretary of the Treasury would be directed to continue to update and improve EPCRS, giving special attention to (1) increasing the awareness and knowledge of small employers concerning the availability and use of EPCRS, (2) taking into account special concerns and circumstances that small employers face with respect to compliance and correction of compliance failures, (3) extending the duration of the self-correction period under APRSC for significant compliance failures, (4) expanding the availability to correct insignificant compliance failures under APRSC during audit, and (5) assuring that any tax, penalty, or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure.

Effective Date

The proposal would be effective on the date of enactment.

XIII. MISCELLANEOUS PROVISIONS

A. Expand the Exclusion from Income for Certain Foster Care Payments

Present Law

Generally, a foster care provider may exclude qualified foster care payments, (including difficulty of care payments) from gross income if certain requirements are satisfied.¹²³ First, such payments must be paid to the foster care providers by either (1) a State or political subdivision of a State; or (2) a tax-exempt placement agency. Second, the payments, including difficulty of care payments, must be paid to the foster care provider for the care of a “qualified foster individual” in the foster care provider’s home. A qualified foster individual is an individual living in a foster care family home in which the individual was placed by: (1) an agency of the State or a political subdivision of a State; or (2) a tax-exempt placement agency if such individual was under the age of 19 at the time of placement. Third, the exclusion of foster care payments generally applies to qualified foster care payments for five or fewer foster care individuals under the age of 19 in a foster home. In the case of difficulty of care payments, the exclusion applies to payments for ten or fewer foster care individuals under the age of 19 in a foster home and to payments for five or fewer foster care individuals at least age 19 in a foster home.

Description of Proposal

The proposal would make two principal modifications to the exclusion. First, the proposal would expand the list of persons eligible to make qualified foster care payments. Therefore, the exclusion would apply to qualified payments made pursuant to a foster care program of a State or local government which are paid by either: (1) a State or political subdivision of a State; or (2) a qualified foster care placement agency, whether taxable or tax-exempt. Second, the proposal would expand the list of persons eligible to place foster care individuals. Specifically, the proposal would allow placements by either: (1) a State or a political subdivision of a State; or (2) a qualified foster care placement agency. For these purposes, a qualified foster care placement agency would be defined as any placement agency which is licensed or certified by: (1) a State or political subdivision of a State; or (2) an entity designated by a State or political subdivision thereof, for the foster care program of such State or political subdivision to make payments to providers of foster care.

The proposal will allow State and local governments to employ both tax-exempt and taxable entities to administer their foster care programs more efficiently; however, it would not extend the exclusion to payments outside such foster care programs (e.g., payments to a foster care provider from friends or relatives of foster care individual in its care).

¹²³ A difficulty of care payment is a payment designated by the person making such payment as compensation for providing the additional care of a qualified foster care individual which is required by reason of a physical, mental, or emotional handicap of such individual and with respect to which the State has determined that there is a need for additional compensation.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

B. Provide Exclusion for Mileage Reimbursements by Charitable Organizations

Present Law

In computing taxable income, individuals who do not elect the standard deduction may claim itemized deductions, including a deduction (subject to certain limitations) for charitable contributions or gifts made during the taxable year to a qualified charitable organization or governmental entity (sec. 170). Individuals who elect the standard deduction may not claim a deduction for charitable contributions made during the taxable year.

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to providing donated services to a qualified charitable organization--such as out-of-pocket transportation expenses necessarily incurred in performing donated services--may constitute a deductible contribution (Treas. Reg. sec. 1.170A-1(g)).¹²⁴ However, no charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel (sec. 170(j)). Moreover, a taxpayer may not deduct as a charitable contribution out-of-pocket expenditures incurred on behalf of a charity if such expenditures are made for the purposes of influencing legislation (sec. 170(f)(6)).

For purposes of computing the charitable contribution deduction for the use of a passenger automobile (including vans, pickups, and panel trucks) in connection with providing donated services to a qualified charitable organization, the standard mileage rate is 14 cents per mile (sec. 170(i)). Volunteer drivers who are reimbursed for mileage expenses have taxable income to the extent the reimbursement exceeds 14 cents per mile.

Description of Proposal

Under the proposal, reimbursement for the costs of using an automobile in connection with providing donated services from an entity or organization described in section 170(c) (including public charities and private foundations) would be excludable from the gross income of the volunteer, provided that (1) reimbursement does not exceed the rate prescribed for business use, and (2) applicable recordkeeping requirements are satisfied. The proposal would not permit a volunteer to exclude a reimbursement from income if the volunteer claims a deduction or credit with respect to his or her automobile transportation expenses incurred in connection with providing donated services.

Effective Date

¹²⁴Treasury Regulation section 1.170A-1(g) allows taxpayers to deduct only their own unreimbursed expenses incurred in performing services for a qualified charitable organization, and not expenses incident to a third party's performance of services. See Davis v. United States, 495 U.S. 472 (1990).

The proposal would be effective for taxable years beginning after December 31, 1999.

C. Consolidate Code Provisions Governing the Hazardous Substance Superfund and the Leaking Underground Storage Tank Trust Fund

Present Law

Present law includes two separate Trust Funds to finance similar ground and water cleanup programs related to hazardous substances. These funds are the Hazardous Substance Superfund (the “Superfund”) and the Leaking Underground Storage Tank Trust Fund (the “LUST Trust Fund”). Amounts in both Trust Funds are available as provided in cross-referenced authorization and appropriations Acts.

Description of Proposal

The Code provisions governing the Superfund and the LUST Trust Fund would be consolidated into a single Environmental Remediation Trust Fund (the “Environmental Trust Fund”). Amounts in the consolidated Trust Fund (i.e., all amounts in both of the present-law Trust Funds) would be available for expenditure, as provided in appropriations Acts, for the combined purposes of the two present-law Trust Funds, as of July 12, 1999.

Provisions like those currently included in the Highway Trust Fund, the Aquatic Resources Trust Fund, and the Vaccine Injury Compensation Trust Fund clarifying that expenditures from the Environmental Trust Fund may occur only as provided in the Code would be incorporated into the new Trust Fund statute, notwithstanding provisions of any other Act (including subsequently enacted non-revenue Act legislation). If any subsequent non-revenue legislation provided for expenditures not provided for in the Code, or if any executive agency authorized such expenditure in contravention of the Code restrictions, excise tax and other Federal revenues otherwise to be deposited in the Environmental Trust Fund would be retained in the General Fund beginning on the date of enactment of such legislation or the date of such executive agency action. Furthermore, no future interest would accrue on the unobligated balances of the Environmental Trust Fund.

Effective Date

The proposal would be effective on October 1, 1999.

**D. Repeal Certain Excise Taxes
on Rail Diesel Fuel and Inland Waterway Barge Fuels**

Present Law

Under present law, diesel fuel used in trains is subject to a 4.4-cents-per gallon excise tax. Revenues from 4.3 cents per gallon of this excise tax are retained in the General Fund of the Treasury. The remaining 0.1 cent per gallon is deposited in the Leaking Underground Storage Tank (“LUST”) Trust Fund.

Similarly, fuels used in barges operating on the designated inland waterways system is subject to a 4.3-cents-per-gallon General Fund excise tax. This tax is in addition to the 20.1-cents-per-gallon tax rates that are imposed on fuels used in these barges to fund the Inland Waterways Trust Fund and the Leaking Underground Storage Tank Trust Fund.

In both cases, the 4.3-cents-per-gallon excise tax rates are permanent. The LUST tax is scheduled to expire after March 31, 2005.

Description of Proposal

The 0.1-cent-per-gallon LUST tax on diesel fuel used in trains would be repealed. In addition, the 4.3-cents-per-gallon General Fund excise tax rates on diesel fuel used in trains and fuels used in barges operating on the designated inland waterways system would be repealed.

Effective Dates

The repeal of the 0.1-cent-per-gallon LUST tax on diesel fuel used in trains would be effective on October 1, 1999. The repeal of the 4.3-cents-per-gallon excise taxes on train diesel and inland waterway barge fuels would be effective after September 30, 2003.

Repeal of these taxes is contingent upon inclusion in the legislation of a separate section of the proposal that would consolidate the Code provisions governing the Hazardous Substance Superfund and the Leaking Underground Storage Tank Trust Fund into an Environmental Remediation Trust Fund.

E. Repeal Excise Tax on Fishing Tackle Boxes

Present Law

Under present law, a 10-percent manufacturer's excise tax is imposed on specified sport fishing equipment. Examples of taxable equipment include fishing rods and poles, fishing reels, artificial bait, fishing lures, line and hooks, and fishing tackle boxes. Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fishing Account of the Aquatic Resources Trust Fund. Monies in the fund are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and safety programs.

Description of Proposal

The excise tax on fishing tackle boxes would be repealed.

Effective Date

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

F. Equalize the Tax Treatment of “Clean Fuel” Vehicles and Oversized Vehicles

Present Law

Taxpayers may claim a credit of 10 percent of the cost of an electric vehicle up to a maximum credit of \$4,000 (sec. 30). Taxpayers may claim an immediate deduction (expensing) for up to \$50,000 of the cost of a qualified clean-fuel vehicle which is a truck or van with a gross vehicle weight greater than 13 tons or a bus with a seating capacity of at least 20 adults (sec. 179A). For the purposes of the deduction permitted under section 179A, electric trucks, vans, or buses are not qualified clean fuel vehicles.

Description of Proposal

The proposal would provide that an electric truck or van with a gross vehicle weight rating greater than 13 tons or an electric bus which has seating capacity of at least 20 adults is a qualified clean fuel vehicle for which the taxpayer may expense up to \$50,000 of cost and that such vehicles are not eligible for the electric vehicle credit.

Effective Date

The proposal would be effective for vehicles placed in service after December 31, 1999.

G. Nuclear Decommissioning

Present Law

Special rules dealing with nuclear decommissioning reserve funds were adopted by Congress in the Deficit Reduction Act of 1984 ("1984 Act") when tax issues regarding the time value of money were addressed generally. Under general tax accounting rules, a deduction for accrual basis taxpayers generally is deferred until there is economic performance for the item for which the deduction is claimed. However, the 1984 Act contains an exception to those rules under which a taxpayer responsible for nuclear power plant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund for future payment costs. Taxpayers who do not elect this provision are subject to the general rules in the 1984 Act.

A qualified decommissioning fund is a segregated fund established by the taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, payment of management costs of the fund, and making investments. The fund is prohibited from dealing with the taxpayer that established the fund. The income of the fund is taxed at a reduced rate of 20 percent¹²⁵ for taxable years beginning after December 31, 1995.

Contributions to the fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to ratepayers. Withdrawal of funds by the taxpayer to pay for decommissioning expenses are included in income at that time, but the taxpayer also is entitled to a deduction at that time for decommissioning expenses as economic performance for those costs occurs.

A taxpayer's contributions to the fund may not exceed the amount of nuclear decommissioning costs included in the taxpayer's cost of service for ratemaking purposes for the taxable year. Additionally, in order to prevent accumulations of funds over the remaining life of a nuclear power plant in excess of those required to pay future decommissioning costs and to ensure that contributions to the funds are not deducted more rapidly than level funding, taxpayers must obtain a ruling from the IRS to establish the maximum contribution that may be made to the fund.

If the decommissioning fund fails to comply with the qualification requirements or when the decommissioning is substantially completed, the fund's qualification may be terminated, in which case the amounts in the fund must be included in income of the taxpayer.

A qualified decommissioning fund may be transferred in connection with the sale, exchange

¹²⁵ As originally enacted in 1984, the fund paid tax on its earnings at the top corporate rate and, as a result, there would be no present-value tax benefit of making deductible contributions to the fund. Also, as originally enacted, the funds in the trust could be invested only in certain low risk investments. Subsequent amendments to the provision have reduced the rate of tax on the fund to 20 percent, and removed the restrictions on the types of permitted investments that the fund can make.

or other transfer of the nuclear power plant to which it relates. If the transferee is a regulated public utility and meets certain other requirements, the transfer will be treated as a nontaxable transaction. No gain or loss will be recognized on the transfer of the qualified decommissioning fund and the transferee will take the transferor's basis in the fund.¹²⁶ The transferee is required to obtain a new ruling amount from the IRS, or accept a discretionary determination by the IRS.¹²⁷ However, if the transferee does not qualify to continue the qualified decommissioning fund, the balance in the fund will be treated as distributed (and thus taxable) at the time of the transfer.

State and Federal regulators may require utilities to set aside funds for nuclear decommissioning purposes in excess of the amount allowed as a deductible contribution to a qualified decommissioning fund. In addition, the taxpayer may have set aside funds prior to the effective date of the qualified decommissioning fund rules. In some cases, a deduction may have been taken for such amounts at the time they were set aside.¹²⁸ These nonqualified funds are not eligible for the special rules that apply to qualified decommissioning funds. Since 1984, no deduction has been allowed with respect to the contribution or segregation of nonqualified funds, and the income on nonqualified funds is taxed to the taxpayer at the taxpayer's marginal rate.

Description of Proposal

The cost of service requirement for deductible contributions to nuclear decommissioning funds would be repealed. Thus, taxpayers, including unregulated taxpayers, would be allowed a deduction for amounts contributed to a qualified nuclear decommissioning fund. As under current law, however, the maximum contribution and deduction for a taxable year could not exceed the IRS ruling amount for that year.

The proposal clarifies the Federal income tax treatment of the transfer of qualified nuclear decommissioning funds. No gain or loss will be recognized to the transferor or the transferee as a result of the transfer of a qualified fund in connection with the transfer of the power plant with respect to which the fund was established.

The proposal provides an election to transfer the balance of certain nonqualified funds to qualified fund. Any portion of the amount transferred that has not previously been deducted would be allowed as a deduction over the remainder of the useful life of the nuclear power plant (as determined for the purpose of the ruling amount) beginning with the first taxable year that begins after 2001. If a qualified fund that has received a transfer from a nonqualified fund is transferred

¹²⁶ Treas. Regs. sec. 1.468A-6.

¹²⁷ Treas. Regs. sec. 1.468A-6(f).

¹²⁸ Prior to July 17, 1984 (the date of enactment of the Deficit Reduction Act of 1984), accrual basis taxpayers could be deduct items without regard to the time the items were economically performed. Some taxpayers may have taken the position that amounts irrevocably set aside for nuclear decommissioning purposes prior to July 17, 1984 were deductible.

to another person, that person will be entitled to the deduction at the same time and in the same manner as the transferor. Thus, if the transferor was not have been subject to tax at the time and thus would have been unable to utilize the deduction, the transferee will similarly not be able to utilize the deduction.

Nonqualified funds eligible to be transferred to a qualified fund are funds that have been irrevocably set aside pursuant to the requirements of a state of Federal agency exclusively for the purpose of funding the decommissioning of the taxpayer's nuclear power plant. Funds that constitute a "prepaid decommissioning fund" or "external sinking trust fund" that would qualify for the purpose of providing financial assurance that funds will be available for the decommissioning process under 10 CFR 50.75.

A new ruling amount must be obtained following the transfer of nonqualified funds to a qualified fund.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

H. Accelerate Scheduled Increase in State Volume Limits on Tax-Exempt Private Activity Bonds

Present Law

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

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

Description of Proposal

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

Effective Date

The volume limit increases would be effective for calendar years after December 31, 1999.

I. Permit Consolidation of Life Insurance and Nonlife Companies

Present Law

Under present law, an affiliated group of corporations means one or more chains of includible corporations connected through stock ownership with a common parent corporation (sec. 1504(a)(1)). The stock ownership requirement consists of an 80-percent voting and value test. In general, an affiliated group of corporations may file a consolidated tax return for Federal income tax purposes.

Life insurance companies (subject to tax under section 801) generally are not treated as includible corporations, and therefore may not be included in a consolidated return of an affiliated group including nonlife-insurance companies, unless the common parent of the group elects to treat the life insurance companies as includible corporations (sec. 1504(c)(2)).

Under the election to treat life insurance companies as includible corporations of an affiliated group, two special 5-year limitation rules apply. The first 5-year rule provides that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed (sec. 1504(c)(2)). The second 5-year rule provides that any net operating loss of a nonlife-insurance member of the group may not offset the taxable income of a life insurance member for any of the first 5 years the life insurance company has been a member of the group (sec. 1503(c)(2)). This rule applies to nonlife losses for the current taxable year or as a carryover or carryback.

A separate 35-percent limitation also applies under the election to treat life insurance companies as includible corporations of an affiliated group (sec. 1503(c)(1)). This rule provides that if the non-life-insurance members of the group have a net operating loss, then the amount of the loss that is not absorbed by carrybacks against the nonlife-insurance members' income may offset the life insurance members' income only to the extent of the lesser of: (1) 35 percent of the amount of the loss; or (2) 35 percent of the life insurance members' taxable income. The unused portion of the loss is available as a carryover and is added to subsequent-year losses, subject to the same 35-percent limitation.

Description of Proposal

The proposal would repeal the two 5-year limitation rules under the election to treat life insurance companies as a member of an affiliated group. The proposal would also repeal the rule that a life insurance corporation is not an includible corporation unless the common parent makes an election to treat life insurance companies as includible corporations. Thus, under the proposal, a life insurance company would be treated as an includible corporation starting with the first taxable year for which it becomes a member of the affiliated group and otherwise meets the definition of an includible corporation. In addition, any net operating loss of a nonlife-insurance member of the group could offset the taxable income of a life insurance member starting with the

first taxable year for which it becomes a member of the affiliated group and otherwise meets the definition of an includible corporation. The proposal would retain the 35-percent limitation of present law with respect to any life insurance company that is an includible corporation of an affiliated group.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 2004.

To the extent that a consolidated net operating loss is created or increased by the proposal, the loss may not be carried back to a taxable year beginning before January 1, 2005. In addition, no affiliated group would terminate solely by reason of the proposal. The proposal would waive the 5-year waiting period for reconsolidation under section 1504(a)(3), in the case of any corporation that was previously an includible corporation, but was subsequently deemed not to be an includible corporation as a result of becoming a subsidiary of a corporation that was not an includible corporation by reason of the 5-year rule of section 1504(c)(2) (providing that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed).

J. Distributions from Publicly Traded Partnerships Treated as Qualifying Income of Regulated Investment Companies

Present Law

A regulated investment company (“RIC”) generally is treated as a conduit for Federal income tax purposes. In computing its taxable income, a RIC deducts dividends paid to its shareholders to achieve conduit treatment (sec. 852(b)). In order to qualify for conduit treatment, a RIC must be a domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or has elected to be treated as a business development company under that Act (sec. 851(a)). In addition, the corporation must elect RIC status, and must satisfy certain other requirements (sec. 851(b)).

One of the requirements is that at least 90 percent of its gross income is derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies. Income derived from a partnership is treated as meeting this requirement only to the extent such income is attributable to items of income of the partnership that would meet the requirement if realized by the RIC in the same manner as realized by the partnership (the “look-through” rule for partnership income). Under present law, no distinction is made under this rule between a publicly traded partnership and any other partnership.

Present law provides that a publicly traded partnership means a partnership, interests in which are traded on an established securities market, or are readily tradable on a secondary market (or the substantial equivalent thereof). In general, a publicly traded partnership is treated as a corporation (sec. 7704(a)), but an exception to corporate treatment is provided if 90 percent or more of its gross income is interest, dividends, real property rents, or certain other types of qualifying income (sec. 7704(c) and (d)).

A special rule for publicly traded partnerships applies under the passive loss rules. The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person. The special rule for publicly traded partnerships provides that the passive loss rules are applied separately with respect to items attributable to each publicly traded partnership (sec. 469(k)). Thus, income or loss from the publicly traded partnership is treated as separate from income or loss from other passive activities.

Description of Proposal

The proposal would modify the 90-percent test with respect to income of a RIC to include income derived from an interest in a publicly traded partnership. The proposal would also modify the lookthrough rule for partnership income of a RIC so that it would apply only to income from a partnership other than a publicly traded partnership.

The proposal would provide that the special rule for publicly traded partnerships under the passive loss rules (requiring separate treatment) applies to a RIC holding an interest in a publicly traded partnership, with respect to items attributable to the interest in the publicly traded partnership.

Effective Date

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

K. Tax Treatment of Alaska Native Settlement Trusts

Present Law

An Alaska Native Settlement Corporation (“ANC”) may establish a Settlement Trust (“trust”) under section 39 of the Alaska Native Claims Settlement Act (“ANCSA”) ¹²⁹ and transfer money or other property to such trust for the benefit of beneficiaries who constitute all or a class of the shareholders of the ANC, to promote the health, education and welfare of the beneficiaries and preserve the heritage and culture of Alaska Natives.

With certain exceptions, once an ANC has made a conveyance to a trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgement, except with respect to the lawful debts and obligations of the trust.

The Internal Revenue Service has indicated that contributions to a trust constitute distributions to the beneficiary-shareholders at the time of the contribution and are treated as dividends to the extent provided under section 301 of the Code. The trust and its beneficiaries are taxed according to the rules of Subchapter J of the Code.

Description of Proposal

An Alaska Native Corporation may establish a Trust under section 39 of ANCSA and if the trust makes an election for its first taxable year ending after December 31, 1999, no amount will be includible in the gross income of a beneficiary of such trust by reason of a contribution to the trust.

The earnings and profits of the ANC would not be reduced by the amount of such contribution. However, the ANC earnings and profits would be reduced (up to the amount of the contribution) as distributions are thereafter made by the Settlement Trust which would exceed the trusts’ total undistributed net income for all prior years during which an election is in effect plus the trust’s distributable net income for the current year, computed under Subchapter J. Beneficiaries of the trust would be taxed on such excess distributions as ordinary income, and reporting to beneficiaries for such amounts could be made on Form 1099 rather than Form K-1.

Apart from these rules, the trust and its beneficiaries would, as under present law, be taxed in accordance with the rules of Subchapter J.

Certain additional restrictions would apply. If the beneficial interests in the trust or shares of the ANC may be sold or exchanged to a person in a manner that would not be permitted under ANCSA (generally, to a person other than an Alaska Native), then future contributions to the trust will be treated as distributions to the beneficiaries at the time of contribution as under present law, and the “excess” distribution provisions described above will not apply with respect to such contributions.

¹²⁹ 43 U.S.C. 1601 et. seq.

In the case of an electing trust, distributions to beneficiaries that would reduce the earnings and profits of an ANC would be subject to withholding to the extent that such distributions, on an annualized basis, exceed the sum of the standard deduction and personal exemption for the taxable year.

Effective Date

The provision would be effective for taxable years of Settlement Trusts, and contributions to such trusts, after December 31, 1999.

**L. Increase Joint Committee on Taxation Refund
Review Threshold to \$2 Million**

Present Law

No refund or credit in excess of \$1,000,000 of any income tax, estate or gift tax, or certain other specified taxes, may be made until 30 days after the date a report on the refund is provided to the Joint Committee on Taxation (sec. 6405). A report is also required in the case of certain tentative refunds. Additionally, the staff of the Joint Committee on Taxation conducts post-audit reviews of large deficiency cases and other select issues.

Description of Proposal

The proposal would increase the threshold above which refunds must be submitted to the Joint Committee on Taxation for review from \$1,000,000 to \$2,000,000. The staff of the Joint Committee on Taxation would continue to exercise its existing statutory authority to conduct a program of expanded post-audit reviews of large deficiency cases and other select issues, and the IRS is expected to cooperate fully in this expanded program.

Effective Date

The proposal would be effective on the date of enactment, except that the higher threshold would not apply to a refund or credit with respect to which a report was made before the date of enactment.

M. Tax Court Proposals

1. Tax Court filing fee

Present Law

Section 7451 authorizes the Tax Court to impose a fee of up to \$60 for the filing of any petition “for the redetermination of a deficiency or for a declaratory judgment under part IV of this Subchapter or under section 7428 or for judicial review under section 6226 or section 6228(a).” The statute does not specifically authorize the Tax Court to impose a filing fee for the filing of a petition for review of the IRS’s failure to abate interest under section 6404 or for administrative costs under section 7430. The practice of the Tax Court is to impose a \$60 filing fee in all cases commenced by petition.

Description of Proposal

Under the proposal, section 7451 would be amended to provide that the Tax Court is authorized to charge a filing fee of up to \$60 in all cases commenced by the filing of a petition.

Effective Date

The proposal would be effective on the date of enactment.

2. Use of practitioner fee

Present Law

Section 7475 authorizes the Tax Court to impose on practitioners a fee of up to \$30 per year and permits these fees to be used to employ independent counsel to pursue disciplinary matters.

Description of Proposal

Tax Court fees imposed on practitioners also would be available to provide services to pro se taxpayers.

Effective Date

The proposal would be effective on the date of enactment.

3. Tax Court authority to apply equitable recoupment

Present Law

Equitable recoupment is a common-law equitable principle which permits the defensive use of an otherwise time-barred claim to reduce or defeat an opponent's claim if both claims arise from the same transaction. U.S. District Courts and the U.S. Court of Federal Claims, the two Federal tax refund forums, may apply equitable recoupment in deciding tax refund cases.¹³⁰ In Estate of Mueller v. Commissioner¹³¹, the Tax Court held that it may apply equitable recoupment in deciding cases over which it has jurisdiction. However, the Court of Appeals for the Sixth Circuit recently held that the Tax Court may not apply the doctrine of equitable recoupment.¹³²

Description of Proposal

Section 6214(b) would be amended to provide that the Tax Court may apply the principle of equitable recoupment to the same extent that it may be applied in Federal civil tax cases by the District Courts and the Court of Federal Claims.¹³³

Effective Date

The proposal would be effective for any action or proceeding in the Tax Court with respect to which a decision has not become final as of the date of enactment.

¹³⁰ See Stone v. White, 301 U.S. 532 (1937), Bull v. United States, 295 U.S. 247 (1935).

¹³¹ 101 T.C. 551 (1993).

¹³² See Estate of Mueller v. Commissioner, 153 F.3d 302 (6th Cir. 1998), cert. den. 525 U.S. ___ (1999). In an earlier case, the Supreme Court specifically reserved ruling on whether the Tax Court may apply equitable recoupment in a case over which it otherwise has jurisdiction. United States v. Dalm, 494 U.S. 596, 611 n.8 (1990).

¹³³ No negative inference is intended with respect to whether the Tax Court has the authority to continue to apply other equitable principles in deciding matters over which it has jurisdiction.

N. Expand Employer Reporting on Annual Wage and Tax Statements

Present Law

An employer must provide certain information annually to each employee in the form of a wage and tax statement ("Form W-2"). The information required to be included on such form includes the individual's name, address, social security number and a statement of total wages, tips, and other compensation for the year. The form must also include the amount of federal income tax withheld as well as the employee's share of social security and medicare taxes withheld for the year by the employer. There is no requirement that the form include a statement of the employer's share of social security and medicare taxes paid by the employer with respect to that individual.

Description of Proposal

The proposal would require the Form W-2 to include a statement of social security and medicare taxes paid by the employer on behalf of each employee.

Effective Date

The proposal would be effective with respect to Form W-2's provided for calendar years beginning after December 31, 1999.

XIV. EXTENSION OF EXPIRING PROVISIONS

A. Extension of Research Tax Credit

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally does not apply to amounts paid or incurred after June 30, 1999.

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

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.¹³⁴

¹³⁴ A special rule is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-based percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-based percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

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

Alternative incremental research credit regime

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

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) “in-house” expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called “contract research expenses”).¹³⁵

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

¹³⁵ Under a special rule, 75 percent of amounts paid or incurred by a taxpayer to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under sec. 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

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

Relation to deduction

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

Description of Proposal

The research tax credit would be extended for five years--i.e., generally, for the period July 1, 1999 through June 30, 2004.

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

Effective Date

Extension of the research credit would be effective for qualified research expenditures paid or incurred during the period July 1, 1999, through June 30, 2004. The increase in the credit rate under the alternative incremental credit would be effective for taxable years beginning after June 30, 1999.

B. Extend Exceptions under Subpart F for Active Financing Income

Present Law

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

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

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

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called “active financing income”). These exceptions are applicable only for taxable years beginning in 1999.¹³⁶

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (“QBU”) of a CFC from transactions with customers is eligible for the exceptions if,

¹³⁶ Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were extended and modified as part of the present-law provision.

among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions are met.

Description of Proposal

The proposal would extend for five years the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Effective Date

The proposal would be effective for taxable years of a foreign corporation beginning after December 31, 1999, and before January 1, 2005, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporation end.

C. Extend Suspension of Income Limitation on Percentage Depletion from Marginal Oil and Gas Wells

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions. In the case of certain properties, the deductions may be determined using the percentage depletion method. Among the limitations that apply in calculating percentage depletion deductions is a restriction that, for oil and gas properties, the amount deducted may not exceed 100 percent of the net income from that property in any year (sec. 613(a)).

Special percentage depletion rules apply to oil and gas production from “marginal” properties (sec. 613A(c)(6)). Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit). Under one such special rule, the 100-percent-of-net-income limitation does not apply to domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

Explanation of Provision

The proposal would extend the present-law rule suspending the 100-percent-of-net-income limitation with respect to oil and gas production from marginal wells to include taxable years beginning after December 31, 1999, and before January 1, 2005.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1999.

D. Extend the Work Opportunity Tax Credit

Present Law

The work opportunity tax credit (“WOTC”) is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit generally is equal to a percentage of qualified wages. The credit percentage is 25 percent for employment of at least 120 hours but less than 400 hours and 40 percent for employment of 400 hours or more. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer.

Generally, no more than \$6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is \$2,400. With respect to qualified summer youth employees, the maximum credit is 40 percent of up to \$3,000 of qualified first-year wages, for a maximum credit of \$1,200. The credit is only effective for wages paid to, or incurred with respect to, qualified individuals who began work for the employer before July 1, 1999.

The employer's deduction for wages is reduced by the amount of the credit.

Description of Proposal

The proposal would extend the WOTC for two years (through June 30, 2001).

The proposal would also include a direction to the Secretary of the Treasury to expedite procedures to allow taxpayers to satisfy their WOTC filing requirements (e.g., Form 8850) by electronic means.

Effective Date

Generally, the proposal would be effective for wages paid to, or incurred with respect to, qualified individuals who begin work for the employer on or after July 1, 1999, and before July 1, 2001.

E. Extend the Welfare-To-Work Tax Credit

Present Law

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

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of this credit) if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

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

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before June 30, 1999.

Description of Proposal

The proposal would extend the welfare-to-work credit for two years, so that the credit would be available for eligible individuals who begin work for an employer before July 1, 2001.

Effective Date

The proposal would be effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1999, and before July 1, 2001.

XV. REVENUE OFFSET PROVISIONS

A. Information Returns Relating to the Discharge of Indebtedness by Certain Entities

Present Law

Under section 61(a)(12), a taxpayer's gross income includes income from the discharge of indebtedness. Section 6050P requires "applicable entities" to file information returns with the IRS regarding any discharge of indebtedness of \$600 or more.

The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided. The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

"Applicable entities" include: (1) the FDIC, the RTC, the National Credit Union Administration, and any successor or subunit of any of them; (2) any financial institution (as described in sec. 581 (relating to banks) or sec. 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. sec. 3701(a)(4)).

The penalties for failure to file correct information reports with the IRS and to furnish statements to taxpayers are similar to those imposed with respect to a failure to provide other information returns. For example, the penalty for failure to furnish statements to taxpayers is generally \$50 per failure, subject to a maximum of \$100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Description of Proposal

The proposal would require that information reporting on discharges of indebtedness also be done by any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies whether or not affiliated with financial institutions).

Effective Date

The proposal would be effective with respect to discharges of indebtedness after December 31, 1999.

B. Extension of IRS User Fees

Present Law

The IRS provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS generally charges a fee for requests for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. Public Law 104-117¹³⁷ extended the statutory authorization for these user fees¹³⁸ through September 30, 2003.

Description of Proposal

The proposal would extend the statutory authorization for these user fees through September 30, 2007. The proposal would also move the statutory authorization for these fees into the Internal Revenue Code.

Effective Date

The proposal would be effective on the date of enactment.

¹³⁷ An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996).

¹³⁸ These user fees were originally enacted in section 10511 of the Revenue Act of 1987 (Public Law 100-203, December 22, 1987).

C. Impose Limitation on Prefunding of Certain Employee Benefits

Present Law

Under present law, contributions to a welfare benefit fund generally are deductible when paid, but only to the extent permitted under the rules of Code sections 419 and 419A. The amount of an employer's deduction in any year for contributions to a welfare benefit fund cannot exceed the fund's qualified cost for the year. The term qualified cost means the sum of (1) the amount that would be deductible for benefits provided during the year if the employer paid them directly and was on the cash method of accounting, and (2) within limits, the amount of any addition to a qualified asset account for the year. A qualified asset account includes any account consisting of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, or life insurance benefits. The account limit for a qualified asset account for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Specific additional reserves are allowed for future provision of post-retirement medical and life insurance benefits.

The present-law deduction limits for contributions to welfare benefit funds do not apply in the case of certain 10-or-more employer plans. A plan is a 10-or-more employer plan if (1) more than one employer contributes to it, (2) no employer is normally required to contribute more than 10 percent of the total contributions under the plan by all employers, and (3) the plan does not maintain experience-rating arrangements with respect to individual employers.

If any portion of a welfare benefit fund reverts to the benefit of an employer that maintains the fund, an excise tax equal to 100 percent of the reversion is imposed on the employer.

Description of Proposal

Under the proposal, the present-law exception to the deduction limit for 10-or-more employer plans would be limited to plans that provide only medical benefits, disability benefits and group-term life insurance benefits which do not provide for any cash surrender value or other money that can be paid, assigned, borrowed or pledged for collateral for a loan. The exception would no longer be available with respect to plans that provide supplemental unemployment compensation, severance pay and life insurance (other than group-term life) benefits. Thus, the generally applicable deduction limits (secs. 419 and 419A) would apply to plans providing these benefits.

In addition, if any portion of a welfare benefit fund attributable to contributions that are deductible pursuant to the 10-or-more employer exception (and earnings thereon) is used for a purpose other than that for which the contributions were made (including cash payments to employees upon termination of the fund), such portion would be treated as reverting to the benefit of the employers maintaining the fund and would be subject to the imposition of the 100-percent excise

tax.

No inference would be intended with respect to the validity of any 10-or-more employer arrangement under the provisions of present law.

Effective Date

The proposal would be effective with respect to contributions paid or accrued on or after June 9, 1999, in taxable years ending after such date.

D. Increase Elective Withholding Rate for Nonperiodic Distributions from Deferred Compensation Plans

Present Law

Present law provides that income tax withholding is required on designated distributions from employer compensation plans (whether or not such plans are tax qualified), individual retirement arrangements (“IRAs”), and commercial annuities unless the payee elects not to have withholding apply. A designated distribution does not include any payment (1) that is wages, (2) the portion of which it is reasonable to believe is not includible in gross income,¹³⁹ (3) that is subject to withholding of tax on nonresident aliens and foreign corporations (or would be subject to such withholding but for a tax treaty), or (4) that is a dividend paid on certain employer securities (as defined in sec. 404(k)(2)).

Tax is generally withheld on the taxable portion of any periodic payment as if the payment is wages to the payee. A periodic payment is a designated distribution that is an annuity or similar periodic payment.

In the case of a nonperiodic distribution, tax generally is withheld at a flat 10-percent rate unless the payee makes an election not to have withholding apply. A nonperiodic distribution is any distribution that is not a periodic distribution. Under current administrative rules, an individual receiving a nonperiodic distribution can designate an amount to be withheld in addition to the 10-percent otherwise required to be withheld.

Under present law, in the case of a nonperiodic distribution that is an eligible rollover distribution, tax is withheld at a 20-percent rate unless the payee elects to have the distribution rolled directly over to an eligible retirement plan (i.e., an IRA, a qualified plan (sec. 401(a)) that is a defined contribution plan permitting direct deposits of rollover contributions, or a qualified annuity plan (sec. 403(a)). In general, an eligible rollover distribution includes any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan or qualified annuity plan. An eligible rollover distribution does not include any distribution that is part of a series of substantially equal periodic payments made (1) for the life (or life expectancy) of the employee or for the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (2) over the a specified period of 10 years or more. An eligible rollover distribution also does not include any distribution required under the minimum distribution rules of section 401(a)(9), hardship distributions from section 401(k) plans, or the portion of a distribution that is not includible in income. The payee of an eligible rollover distribution can only elect not to have withholding apply by making the direct rollover election.

¹³⁹All IRA distributions are treated as if includible in income for purposes of this rule.

Description of Proposal

Under the proposal, the withholding rate for nonperiodic distributions would be increased from 10 percent to 15 percent. As under present law, unless the distribution was an eligible rollover distribution, the payee could elect not to have withholding apply. The proposal would not modify the 20-percent withholding rate that applies to any distribution that is an eligible rollover distribution.

Effective Date

The proposal would be effective for distributions made after December 31, 1999.

E. Modify Treatment of Closely-Held REITs

Present Law

In general, a real estate investment trust (“REIT”) is an entity that receives most of its income from passive real estate related investments and that receives pass-through treatment for income that is distributed to shareholders. If an electing entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to tax at the REIT level.

A REIT must satisfy a number of tests on a year-by-year basis that relate to the entity's: (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income.

Under the organizational structure test, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination.

Description of Proposal

The proposal would impose as an additional requirement for REIT qualification that, except for the first taxable year for which an entity elects to be a REIT, no person can own stock of a REIT possessing 50 percent or more of the combined voting power of all classes of voting stock or 50 percent or more of the total value of shares of all classes of stock. For purposes of determining a person's stock ownership, rules similar to attribution rules for REIT qualification under present law would apply (secs. 856(d)(5) and 856(h)(3)). The proposal would not apply to ownership by a REIT of 50 percent or more of the stock (vote or value) of another REIT.

An exception would apply for a limited period to certain “incubator REITs”. An incubator REIT would be a corporation that elects to be treated as an incubator REIT and that meets all the following other requirements. (1) it has only voting common stock outstanding, (2) not more than 50 percent of the corporation’s real estate assets consist of mortgages, (3) from not later than the beginning of the last half of the second taxable year, at least 10 percent of the corporation’s capital is provided by lenders or equity investors who are unrelated to the corporation’s largest shareholder, (4) the directors of the corporation adopt a resolution setting forth an intent to engage in a going public transaction, and (5) no predecessor entity (including any entity from which the electing incubator REIT acquired assets in a transaction in which gain or loss was not recognized in whole or in part) had elected incubator REIT status.

The new ownership requirement would not apply to an electing incubator REIT until the end of the REIT’s third taxable year; and could be extended for an additional two taxable years if the REIT so elects. However, a REIT cannot elect the additional two year extension unless the REIT agrees that if it does not engage in a going public transaction by the end of the extended eligibility

period, it shall pay Federal income taxes for the two years of the extended period as if it had not made an incubator REIT election and had ceased to qualify as a REIT for those two taxable years. In such case, the corporation shall file appropriate amended returns with 3 months of the close of the extended eligibility period. Interest would be payable, but no substantial underpayment penalties would apply except in cases where there is a finding that incubator REIT status was elected for a principal purpose other than as part of a reasonable plan to engage in a going public transaction. Notification of shareholders and any other person whose tax position would reasonably be expected to be affected is also required.

If an electing incubator REIT does not elect to extend its initial 2-year extended eligibility period and has not engaged in a going public transaction by the end of such period, it must satisfy the new control requirements as of the beginning of its fourth taxable year (i.e., immediately after the close of the last taxable year of the two-year initial extension period) or it will be required to notify its shareholders and other persons that may be affected by its tax status, and pay Federal income tax as a corporation that has ceased to qualify as a REIT as of that time.

If the Secretary of the Treasury determines that an incubator REIT election was filed for a principal purpose other than as part of a reasonable plan to undertake a going public transaction, an excise tax of \$20,000 would be imposed on each of the corporation's directors for each taxable year for which the election was in effect.

A going public transaction would be defined as either (1) a public offering of shares of stock of the incubator REIT, (2) a transaction, or series of transactions, that result in the incubator REIT stock being regularly traded on an established securities market (as defined in section 897) and being held by shareholders unrelated to persons who held such stock before it began to be so regularly traded, or (3) any transaction resulting in ownership of the REIT by 200 or more persons (excluding the largest single shareholder) who in the aggregate own least 50 percent of the stock of the REIT. Attribution rules apply in determining ownership of stock.

Effective Date

The proposal would be effective for entities electing REIT status for taxable years ending after July 12, 1999. Any entity that elects REIT status for a taxable year ending on or before July 12, 1999 and which has significant business assets or activities as of such date will not be subject to the proposal.

F. Limit Conversion of Character of Income from Constructive Ownership Transactions

Present Law

The maximum individual income tax rate on ordinary income and short-term capital gain is 39.6 percent, while the maximum individual income tax rate on long-term capital gain generally is 20 percent. Long-term capital gain means gain from the sale or exchange of a capital asset held more than one year. For this purpose, gain from the termination of a right with respect to property which would be a capital asset in the hands of the taxpayer is treated as capital gain.¹⁴⁰

A pass-thru entity (such as a partnership) generally is not subject to Federal income tax. Rather, each owner includes its share of pass-thru entity's income, gain, loss, deduction or credit in its taxable income. Generally, the character of the item is determined at the entity level and flows through to the owners. Thus, for example, the treatment of income by a partnership as ordinary income, short-term capital gain, or long-term capital gain retains its character when reported by each of the partners.

Investors may enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property that provide the investor with the same or similar economic benefits as owning the property directly but with potentially different tax consequences (as to the character and timing of any gain).

Description of Proposal

The proposal would limit the amount of long-term capital gain a taxpayer could recognize from certain derivative contracts ("constructive ownership transaction") with respect to certain financial assets. The amount of long-term capital gain would be limited to the amount of such gain the taxpayer would have had if the taxpayer held the financial asset directly during the term of the derivative contract. Any gain in excess of this amount would be treated as ordinary income. An interest charge would be imposed on the amount of gain that is treated as ordinary income.

A taxpayer would be treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to a financial asset, (2) enters into a forward contract to acquire a financial asset, (3) is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

A "financial asset" would be defined as (1) any equity interest in a pass-thru entity, and (2) to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-thru entity. A "pass-thru entity" would be defined as (1) a regulated investment company, (2)

¹⁴⁰ Section 1234A, as amended by the Taxpayer Relief Act of 1997.

a real estate investment trust, (3) an S corporation, (4) a partnership, (5) a trust, (6) a common trust fund, (7) a passive foreign investment company, (8) a foreign personal holding company, and (9) a foreign investment company.

The interest charge is the amount of interest that would be imposed under section 6601 had the recharacterized gain been included in the taxpayer's income during the term of the constructive ownership transaction. The recharacterized gain is treated as having accrued at a constant rate¹⁴¹ during the term of the constructive ownership transaction.

A taxpayer would be treated as holding a long position under a notional principal contract with respect to a financial asset if the person (1) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the partnership interest for a specified period, and (2) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the partnership interest. A forward contract is a contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

Effective Date

This proposal would apply to transactions entered into on or after July 12, 1999.

¹⁴¹ The accrual rate would be the applicable Federal rate on the day the constructive ownership transaction closed.

G. Treatment of Excess Pension Assets Used for Retiree Health Benefits

Present Law

Defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate, which may be as high as 50 percent of the reversion, varies depending upon whether or not the employer maintains a replacement plan or makes certain benefit increases. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a section 401(h) account that is a part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multiemployer plan) into a section 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, vesting requirements and minimum benefit requirements. Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the section 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) out of transferred assets. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

No deduction is allowed for (1) a qualified transfer of excess pension assets into a section 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer.

The minimum benefit requirement requires each group health plan under which applicable health benefits are provided to provide substantially the same level of applicable health benefits for the taxable year of the transfer and the following 4 taxable years. The level of benefits that must be maintained is based on benefits provided in the year immediately preceding the taxable year of the transfer. Applicable health benefits are health benefits or coverage that are provided to (1) retirees who, immediately before the transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan and (2) the spouses and dependents of such retirees.

The provision permitting a qualified transfer of excess pension assets to pay qualified current retiree health liabilities expires for taxable years beginning after December 31, 2000.¹⁴²

Description of Proposal

The present-law provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under a section 401(h) account would be extended through September 30, 2009. In addition, the present-law minimum benefit requirement would be replaced by the minimum cost requirement that applied to qualified transfers before December 9, 1994, to section 401(h) accounts. Therefore, each group health plan or arrangement under which applicable health benefits are provided would be required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following 4 taxable years. The minimum dollar level would be the higher of the applicable employer costs for each of the 2 taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year would be determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year.

Effective Date

The proposal generally would be effective with respect to qualified transfers of excess defined benefit pension plan assets to section 401(h) accounts after December 31, 2000, and before October 1, 2009. The modification of the minimum benefit requirement would be effective with respect to transfers after the date of enactment.

¹⁴²Similar provisions regarding transfers of excess defined benefit pension plan assets to retiree health accounts are contained in Title I of ERISA.

H. Modify Installment Method and Prohibit its Use by Accrual Method Taxpayers

Present Law

An accrual method taxpayer is generally required to recognize income when all the events have occurred that fix the right to the receipt of the income and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle of income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(l)(2)(B)) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds¹⁴³ of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), or to dispositions where the sales price does not exceed \$150,000.

An additional rule requires the payment of interest on the deferred tax that is attributable to most large installment sales.

Description of Proposal

Prohibit use of installment method for accrual method dispositions

The proposal generally would prohibit the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting. The proposal would not change present law regarding the availability of the installment method for dispositions of property used or produced in the trade or business of farming. The proposal also would not change present law regarding the availability of the installment method for dispositions of timeshares or residential lots if the taxpayer elects to pay interest under section 453(l).

The proposal does not change the ability of a cash method taxpayer to use the installment method. For example, a cash method individual owns all of the stock of a closely held accrual method corporation. This individual sells his stock for cash, a ten year note, and a percentage of the gross revenues of the company for next ten years. The proposal would not change the ability of

¹⁴³ The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

this individual to use the installment method in reporting the gain on the sale of the stock.

Modify pledge rule

The proposal would also modify the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer only recognizes gain as it receives the deferred payment. However, were the taxpayer to pledge the installment note as security for a loan, it would be required to treat the proceeds of such loan as a payment on the installment note, and recognize the appropriate amount of gain. Under the proposal, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to “put” or repay the loan by transferring the installment note to the taxpayer’s creditor. Other arrangements that have a similar effect would be treated in the same manner.

The proposed modification of the pledge rule would only apply to installment sales where the pledge rule of present law applies. Accordingly, the proposal would not apply to installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(1)(2)(B), to sales of property used or produced in the trade or business of farming, or to dispositions where the sales price does not exceed \$150,000, since such sales are not subject to the pledge rule under present law.

Effective Date

The proposal prohibiting the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting would be effective for installment sales entered into on or after the date of enactment. The proposal modifying the pledge rules would be effective for arrangements entered into on or after the date of enactment.

XVI. TAX TECHNICAL CORRECTIONS

The following technical corrections provisions would be adopted. Except as otherwise provided, the technical corrections generally would be effective as if included in the originally enacted related legislation.

Amendments related to Tax and Trade Relief Extension Act of 1998

Exempt organizations.—The proposed change would clarify that nonexempt charitable trusts and nonexempt private foundations are subject to the public disclosure requirements of section 6104(d).

Capital gains.—The proposed change would provide that if (1) a charitable remainder trust sold section 1250 property after July 28, 1997, and before January 1, 1998, (2) the property was held more than one year but not more than 18 months, and (3) the capital gain is distributed after December 31, 1997, then any capital gain attributable to depreciation will be taxed at 25 percent (rather than 28 percent). Treasury has published a notice (Notice 99-17, 1999-14 I.R.B., April 5, 1999) providing that the gain is taxed at 25 percent.

Vaccine Trust Fund.—In the 1998 Act, the tax on vaccines against rotavirus gastroenteritis and the technical correction regarding the Vaccine Injury Compensation Trust Fund expenditure purposes were inadvertently included twice, once in the spending title and once in the revenue title. In addition, in the spending title, the effective date of the substantive change to the expenditure program is drafted erroneously, such that claims to the Trust Fund for this new expenditure purpose cannot be paid. The proposed changes would clarify that intended vaccine tax and Trust Fund provisions regarding program spending authority are those included in the revenue title, and would modify the revenue title provisions as necessary to allow spending for the new purpose created elsewhere in the Act.

Amendments related to Internal Revenue Service Restructuring and Reform Act of 1998

IRS restructuring.—When the Office of the Chief Inspector was replaced by the Treasury Inspector General for Tax Administration (TIGTA) under the IRS Restructuring and Reform Act of 1998, Inspection's responsibilities were assigned to the TIGTA. TIGTA personnel are Treasury, rather than IRS, personnel. TIGTA personnel still need to make investigative disclosures to carry out the duties they took over from Inspection and their additional tax administration responsibilities. However, section 6103(k)(6) refers only to "internal revenue" personnel. The proposed change would clarify that section 6103(k)(6) permits TIGTA personnel to make investigative disclosures.

Compliance.—Section 3509 of the IRS Restructuring and Reform Act of 1998 expanded the disclosure rules of section 6110 to also cover Chief Counsel advice (sec. 6110(i)). This is a conforming change related to ongoing investigations. The proposed change would add to section 6110(g)(5)(A) after the words technical advice memorandum, "or Chief Counsel advice."

Amendments related to Taxpayer Relief Act of 1997

Roth IRAs.--Code section 3405 provides for withholding with respect to designated distributions from certain tax-favored arrangements, including IRAs. In general, section 3405(e)(1)(B)(ii) excludes from the definition of a designated distribution the portion of any distribution which it is reasonable to believe is excludable from gross income. However, all distributions from IRAs are treated as includible in income. The exception was consistent with prior law when all IRA distributions were taxable, but does not account for the tax-free nature of certain Roth IRA distributions. The proposed change would extend the exception to Roth IRAs.

Transportation benefits.--Under present law, salary reduction amounts are generally treated as compensation for purposes of the limits on contributions and benefits under qualified plans. In addition, an employer can elect whether or not to include such amounts for nondiscrimination testing purposes. The IRS Reform Act permitted employers to offer a cash option in lieu of qualified transportation benefits. The proposed change would treat salary reduction amounts used for qualified transportation benefits the same as other salary reduction amounts for purposes of defining compensation under the qualified plan rules.

Tax Court jurisdiction.--The Tax Court recently held that its jurisdiction pursuant to section 7436 extends only to employment status, not to the amount of employment tax in dispute (Henry Randolph Consulting v. Comm’r, 112 T.C. #1, Jan. 6, 1999). The proposed change would provide that the Tax Court also has jurisdiction over the amount.

Amendments to other Acts

Worthless securities.--Section 165(g)(3) provides a special rule for worthless securities of an affiliated corporation. The test for affiliation in section 165(g)(3)(A) is the 80-percent vote test for affiliated groups under section 1504(a) that was in effect prior to 1984. When section 1504(a) was amended in the Deficit Reduction Act of 1984 to adopt the vote and value test of present law, no corresponding change was made to section 165(g)(3)(A), even though the test had been the same until then. The proposed change would conform the affiliation test of section 165(g)(3)(A) to the test in section 1504(a)(2), effective for taxable years beginning after December 31, 1984.

Work opportunity tax credit.--Section 51(d)(2) refers to eligibility for the work opportunity tax credit with respect to certain welfare recipients without taking into account the enactment of the temporary assistance for needy families (“TANF”) program. The proposed changes would conform references in the work opportunity tax credit to the operation of TANF, effective as if included in the amendments made by section 1201 of the Small Business Job Protection Act of 1996.

IRAs for nonworking spouses.--Section 1427 of the Small Business Job Protection Act of 1996 expanded the IRA deduction for nonworking spouses. The maximum permitted IRA contributions is generally limited by the individual’s earned income. However, under present law, it is possible for a nonworking (or lesser earning) spouse to make IRA contributions in excess of the couple’s combined earned income. The following example illustrates present law.

Example: Suppose H and W retire in the middle of January, 1999. In that year, H earns \$1,000 and W earns \$500. Both are active participants in an employer-sponsored retirement plan. Their modified AGI is \$60,000. They make no Roth IRA contributions. Before application of the income phase-out rules, the maximum deductible IRA contribution that H can make is \$1,000 (sec. 219(b)(1)). After application of the income phase-out rule in section 219(g), H's maximum contribution is \$200, and H contributes that amount to an IRA. Under 408(o)(2)(B), H can make nondeductible contributions of \$800 (\$1,000 - \$200).

W's maximum permitted deductible contribution under section 219(c)(1)(B), before the income phase-out, is \$1,300 (the sum of H and W's earned income (\$1,500), less H's deductible IRA contribution (\$200)). Under the income phase-out, W's deductible contribution is limited to \$200, and she can make a nondeductible contribution of \$1,000 (\$1,300 - \$200).

The total permitted contributions for H and W are \$2,300 (\$1,000 for H plus \$1,300 for W). The combined contribution should be limited to \$1,500, their combined earned income.

The proposed change would provide that the contributions for the spouse with the lesser income cannot exceed the combined earned income of the spouses. The proposal would be effective for taxable years beginning after December 31, 1999.

Insurance.--The legislative history of section 7702A(a) (enacted in the Technical and Miscellaneous Revenue Act of 1988) indicated that if a life insurance contract became a modified endowment contract ("MEC"), then the MEC status could not be eliminated by exchanging the MEC for another contract. Section 7702A(a)(2), however, arguably might be read to allow a policyholder to exchange a MEC for a contract that does not fail the 7-pay test of section 7702A(b), then exchange the second contract for a third contract, which would not literally have been received in exchange for a contract that failed to meet the 7-pay test. The proposed change would clarify section 7702A(a)(2) to correspond to the legislative history, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Insurance.--Under section 7702A, if a life insurance contract that is not a modified endowment contract is actually or deemed exchanged for a new life insurance contract, then the 7-pay limit under the new contract is first be computed without reference to the premium paid using the cash surrender value of the old contract, and then would be reduced by 1/7 of the premium paid taking into account the cash surrender value of the old contract. For example, if the old contract had a cash surrender value of \$14,000 and the 7-pay premium on the new contract would equal \$10,000 per year but for the fact that there was an exchange, the 7-pay premium on the new contract would equal \$8,000 (\$10,000 - \$14,000/7). However, section 7702a(c)(3)(A) arguably might be read to suggest that if the cash surrender value on the new contract was \$0 in the first two years (due to surrender charges), then the 7-pay premium might be \$10,000 in this example, unintentionally permitting policyholders to engage in a series of "material changes" to circumvent the premium

limitations in section 7702A. The proposed change would clarify section 7702A(c)(3)(A) to refer to the cash surrender value of the old contract, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Definition of lump-sum distribution.--Section 1401(b) of the Small Business Job Protection Act of 1996 Act repealed 5-year averaging for lump-sum distributions. The definition of lump-sum distribution was preserved for other provisions, primarily those relating to NUA in employer securities. The definition was moved from section 402(d)(4)(A) to section 402(e)(4)(D)(i). This definition included the following sentence: "A distribution of an annuity contract from a trust or annuity plan referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution." The proposed change would add this language back into the definition of lump-sum distribution, effective as if included with section 1401 of the Small Business Job Protection Act of 1996. The sentence is relevant to section 401(k)(10)(B), which permits certain distributions if made as a "lump-sum distribution."

Losses from section 1256 contracts.--Section 6411 allows tentative refunds for NOL carrybacks, business credit carrybacks and, for corporations only, capital loss carrybacks. Individuals normally cannot carry back a capital loss. However, section 1212(c) does allow a carryback of section 1256 losses, if elected by the taxpayer. The proposed change would amend section 6411(a) by including a reference to section 1212(c), effective as if included with section 504 of the Economic Recovery Tax Act of 1981.

Clerical changes

Individual.--Section 67(f), as enacted in 1988, has a cross reference to "the last sentence of section 162(a)." Additional "last sentences" were later added at the end of section 162(a) in 1992 and 1997. The proposed change would correct the reference in section 67(f).

Excess contributions.--The proposed change would modify the heading for section 408(d)(5) to "Distributions of excess contributions after due date for taxable year and certain excess rollover contributions."

Qualified State tuition programs.--Under section 529(e)(3)(B) (enacted in the Small Business Job Protection Act of 1996), qualified higher education expenses include room and board expenses of a designated beneficiary who is enrolled at least half-time in a degree program, regardless of whether the qualified state tuition program is a prepaid (i.e., guaranteed) program or a savings program. Therefore, the proposed change would delete the words "under guaranteed plans" from the heading of section 529(e)(3)(B).

S corporations.--Sections 678(e) and 6103(e)(1)(D)(v) refer to "an electing small business corporation under Subchapter S of chapter 1." The reference was inadvertently not changed to "S corporation" when the Subchapter S Revision Act was enacted in 1982, and the proposed change would correct the reference.

Foreign–Military FSCs.--The Tax Reform Act of 1976 added section 995(b)(3)(B), limiting DISC benefits relating to “military property,” which is defined by reference to a list under the “Military Security Act of 1954.” That Act properly was titled the “Mutual Security Act of 1954,” and it had been repealed and superseded by the “International Security Assistance and Arms Export Control Act of 1976” (signed into law June 30, 1976). Section 923 (relating to FSCs) also refers to the definition in section 995(b)(3)(B). Treasury regulations correctly reference the International Security Assistance and Arms Export Control Act of 1976. The proposed change would name the correct Act in the statute.

Private foundation excise taxes.--Section 4946 provides a definition of “government official” for purposes of determining acts of self-dealing under section 4941. In section 4946(c)(3)(B), the definition refers to “compensation at the lowest rate prescribed for GS-16” The proposed change would change this language so that it refers to compensation at the lowest rate prescribed for Senior Executive Service (SES) positions.