[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 3475: TAX LAW SIMPLIFICATION AND IMPROVEMENT ACT OF 1983

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON JULY 25, 1983

PREPARED BY THE STAFF

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on July 25, 1983, on H.R. 3475 (The Tax Law Simplification and Improvement Act of 1983), introduced by Chairman Rostenkowski and Congressman Conable.

The first part of this pamphlet is a summary of the provisions of the bill. This is followed by a more detailed description of the provisions, including present law, issues, explanation of provisions, effective dates, and estimated revenue effects. The bill is divided into 9 titles.

I. SUMMARY

A. Estimated Income Tax for Individuals

The individual estimated income tax rules of present law would be simplified and clarified by the bill. Generally, an individual would be required to make estimated tax payments (including withholding payments) equal to 80 percent of the current year's tax or 100 percent of the prior year's tax. Payments based on annualized income would be allowed. The due date for the second installment payment, currently June 15, would be moved to July 15. The Secretary could waive the penalty for failure to make payments where there was reasonable cause for the failure.

The provision would be effective for taxable years beginning after 1983.

B. Domestic Relations

Transfers of property between spouses or incident to divorce

Under present law, gain is recognized on certain transfers of property in exchange for marital rights of a spouse or former spouse. The bill would provide that property transfers between spouses or, if incident to divorce, between former spouses, would not result in the recognition of gain or loss. The transferee would hold the property at the transferor's basis.

The provision would generally be effective for transfers after the date of enactment of the bill.

Alimony

Under present law, alimony is deductible by the payor and includible in the income of the payee. The bill would revise the rules relating to the definition of alimony. Generally, only cash payments that will terminate on the death of the payee spouse would qualify as alimony. The present law requirement that the payment be based on a legal support obligation would be repealed. Payors would be required to furnish to the IRS the social security number of the payee spouse. A $50 penalty for failure to do so would be imposed.

The provision would generally be effective for divorce or separation agreements or orders executed after 1983.

Dependency exemption for children of divorced parents, etc.

The bill would provide that the $1,000 dependency exemption for a child of divorced or separated parents generally would be allocated to the custodial parent unless the custodial parent signs a written declaration that he or she will not claim the exemption for the year. Each parent could claim the medical expenses that he or she pays for the child, for purposes of computing the medical deduction.

The provision would be effective for taxable years beginning after 1983.

Innocent spouse relieved of liability in certain cases

Under present law, a spouse may be relieved of liability where he or she signs a joint return and there was a substantial omission of income attributable to the other spouse. The bill would extend these rules to situations involving claims of grossly erroneous deductions and credits and would replace the substantial omission of income test with a substantial understatement of tax test. Also, the bill would override community property laws in certain situations where it is equitable to do so.

Estate tax treatment of certain property settlements

The bill would conform the estate tax treatment with respect to transfers of property to a former spouse under certain property settlements with the present law allowing a gift tax deduction for such transfers. The provision would apply to estates of decedents dying after date of enactment of the bill.

C. Investment Tax Credit At Risk Rules

The bill would amend the at-risk limitation on the investment tax credit by providing that the base for the credit would be reduced by nonrecourse indebtedness related to the property (i.e., a loan on which there is no personal liability). Qualified commercial financing, defined as financing from an unrelated party regularly engaged in commercial lending where no more than 80 percent of all financing for the property is nonrecourse, would be excluded from the limitation. In the case of an S corporation, recourse financing at the corporate level that is provided by a qualified commercial leader would be considered recourse financing at the shareholder level if the debt is related to property used by the corporation in an active trade or business with at least 3 full-time employees.

The provisions generally would generally apply to property placed in service in taxable years ending after the date of enactment of the bill.

D. Estate Tax Revisions

Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests

Under the rules adopted by the Tax Reform Act of 1969, a charitable interest in a split-interest trust (i.e., a trust which is part charitable and part noncharitable) must be in certain specified forms to be deductible for Federal income, gift, and estate tax purposes. Present law permits defective governing instruments of charitable split-interest trusts which where created pursuant to wills executed before January 1, 1979, to be amended to conform to the 1969 Act rules by December 31, 1981.

The bill would provide a permanent rule permitting reformation of governing instruments of charitable split-interest trusts which do not meet the requirements of the 1969 Act rules where the instrument evidences an intent to comply with the 1969 Act rules and the actuarial values and durations of the charitable and noncharitable interests in the trust generally remain the same before and after the reformation.

This provision would be effective with respect to reformations made after December 31, 1981.

Alternate valuation date election

Under present law, the value of property includible in the decedent's gross estate for Federal estate tax purposes generally is determined on the date of the decedent's death. However, the executor of the decedent's estate may elect to have the value of all property included in the gross estate determined as of the alternate valuation date (which generally is six months after the decedent's death). The election to use the alternate valuation date may be made only on a timely filed Federal estate tax return. Also, under present law, the Federal income tax basis of property acquired from a decedent generally is its value for Federal estate tax purposes.

The bill would provide that the election to use the alternate valuation date may be made only where both the total value of all property in the gross estate and the Federal estate tax liability of the estate are reduced by making the election. The bill would also allow the alternate valuation election to be made on the first estate tax return filed (whether filed timely or late).

This provision would be effective with respect to estates of decedents dying after the date of enactment of the bill.

E. Foreign Tax Provisions

Resident alien definition

The bill would make several changes in the tax provisions affecting foreign income and foreign taxpayers. It would provide standards for determining whether an alien individual is a resident of the United States. Under these standards, an individual who spends substantial time in the United States over a three-year period would generally be a U.S. resident. A permanent resident for immigration purposes (or an applicant for permanent residence who spends at least 60 days during the year in the United States) would be a U.S. resident, also. The bill would prevent married nonresident aliens from using the community property laws of their home country to split income for U.S. tax purposes.

Foreign personal holding company attribution rules

The bill would clarify the family attribution rules for determining when a foreign corporation is a foreign personal holding company. It would also prevent avoidance of U.S. tax by interposition of a foreign trust or another foreign entity between a foreign personal holding company and a U.S. taxpayer.

Ordinary income treatment under section 1248

The bill would clarify the rules that tax the previously untaxed earnings and profits of a controlled foreign corporation at ordinary income rates when its U.S. owner disposes of or liquidates it. It would prevent later double taxation of those earnings and profits and double crediting of associated foreign taxes. It would also treat direct ownership of a controlled foreign corporation like indirect ownership for the purpose of these rules.

Coordination of subpart F with foreign personal holding company provisions

The bill would coordinate the foreign personal holding company rules with the controlled foreign corporation rules. It would provide that shareholders of a controlled foreign corporation (that is also a foreign personal holding company) are subject to the controlled foreign corporation rules to the extent that income taxable under those rules exceeds income taxable under the foreign personal holding company rules.

Stapled stock

The bill also contains provisions regarding so-called stapled stock. It would provide generally that if a foreign and a domestic corporation are stapled entities, the foreign corporation would be treated as domestic. In addition, if two domestic corporations are stapled entities, each would be treated as owning the other.

F. Miscellaneous Treasury Administrative Provisions

The bill would make a number of minor amendments relating to Treasury administrative provisions. The bill would simplify certain reporting requirements, remove the $1 million limitation of the Treasury working capital fund, increase the authorization limit from $1 million to $10 million on the revolving fund for the redemption of real property, allow the Secretary of the Treasury to accept gifts and bequests for the Treasury Department, repeal the stamp requirement for distilled spirits and allow an extension of time for court review of jeopardy assessment where the government is not promptly served.

G. Tax Court Provisions

The bill would allow certified public accountants and enrolled agents authorized to practice before the Internal Revenue Service to represent taxpayers in small claim cases before the Tax Court. Persons other than attorneys would no longer be admitted to practice before the Tax Court. The title of the Tax Court "commissioners" would be changed to "special trial judges". The bill would provide that that Tax Court may prevent public disclosure of trade secrets or other confidential information.

H. Simplification of Income Tax Credits

In general, the bill would group existing income tax credits into logical categories and would provide uniform tax liability limitations and carryover rules. The business credits (i.e., investment tax credit, targeted jobs credit, alcohol fuels credit, research credit, and ESOP credit) would be combined into one credit and allowed up to 100 percent of the first $25,000 of tax liability and 85 percent of the remainder. A 3-year carryback and 15-year carryforward period on a FIFO basis would be allowed for the business credit.

This provision would apply to taxable years beginning after 1983.

I. Repeal of Certain Obsolete Provisions (Deadwood)

Three provisions (Code sections 405, 409, and 1251) would be repealed as deadwood.

II. DESCRIPTION OF THE BILL

A. Estimated Income Tax for Individuals (Title I of the bill and sec. 6654 of the Code)

Present Law

Under present law, an individual who fails to pay an installment of estimated income tax on or before the due date generally is subject to a penalty at the rate established for interest (under sec. 6621). The penalty may not be waived for reasonable cause. The penalty is computed by applying the interest rate to the amount of the underpayment of the installment for the period of the underpayment. The amount of the underpayment is the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year, divided by the number of installments that should have been made. Payments are required on April 15, June 15, September 15, and January 15 of the following year.

There are four exceptions to the general underpayment penalty. No penalty is imposed upon a taxpayer if total tax payments (withholding plus estimated tax payments) equal or exceed an installment based on (1) the preceding year's tax liability, if a return showing a liability for tax was filed for the preceding year; (2) 80 percent of the taxes which would be due if the income already received during the current year were placed on annual basis; (3) 90 percent of the tax which would be due on the income actually received from the beginning of the year to the computation date; or (4) the tax computed by using the facts shown on the prior year's return under the current year's tax rates and exemptions. Also, no penalty is imposed where the tax is less than a minimal amount ($300 in 1983, $400 in 1984, and $500 in 1985 and thereafter), or where there was no tax liability for the preceding taxable year.

Issues

The issues include—

(1) whether the amount of the underpayment should be measured from the lesser of last year's tax or 80 percent of the current year's tax;

(2) whether the exception from the penalty based on 90 percent of the current year's income to date (exception (3)) and the exception based on last year's income at the current year's rates (exception (4)) should be repealed;

(3) whether a reasonable cause exception should be added; and

(4) whether the June 15 payment date should be moved to July 15 to more closely conform the payment dates to quarterly payments.

Explanation of Provisions

The bill would make a number of modifications to the present law requirements and would consolidate all the rules into one section of the Code. Under the bill, the underpayment penalty with respect to any installment would apply to the difference between payments made by the due date of the installment and the lesser of an installment based on 80 percent of the tax shown on the preceding year's return or 100 percent of the tax shown on the preceding year's return, if a return was filed for the preceding year. Adjustments to the amount shown on the return would be taken into account. No penalty would be imposed if the total payments exceed 80 percent of the taxes which would be due if the income already received during the current year were placed on an annual basis. The exceptions from the penalty described in paragraphs (3) and (4) of present law would be repealed.

The Internal Revenue Service could waive the penalty if the failure to make a payment was due to reasonable cause. This waiver could be granted only in extraordinary circumstances, such as destruction of the taxpayer's books and records by fire or other casualty, or in certain circumstances, the death or serious illness of the taxpayer.

The due date for the second installment payment would be changed to July 15, so that payments would be due on the 15th of April, July, September, and of January of the following year.

Effective Date

The provisions would be effective for taxable years beginning after December 31, 1983.

Revenue Effect

The repeal of the "90 percent" and "this year's tax rates" exceptions from the penalty would increase revenues by $105 million in fiscal year 1984, would not have a revenue effect in fiscal year 1985, would increase revenues by $4 million in fiscal year 1986, $9 million in fiscal year 1987, and $11 million in fiscal year 1988.

The provision measuring the penalty from last year's return would reduce revenues by $40 million a year beginning in fiscal year 1985.

The provision allowing a waiver for reasonable cause would reduce revenues by less than $5 million a year beginning in fiscal year 1984.

The provision changing the June 15 payment date to July 15 would increase budget outlays by approximately $100 million a year beginning in fiscal year 1984 (resulting from interest paid on increased Treasury borrowing).

B. Domestic Relations (Title II of the Bill)

1. Treatment of Transfer of Property Between Spouses or Incident to Divorce (sec. 202 of the bill and sec. 1041 of the Code)

Present Law

Under present law, the Supreme Court has ruled that a transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims results in the recognition of gain to the transferor *(United States* v. *Davis* (370 U.S. 65 (1962)). The spouse receiving the property receives a basis in the asset transferred equal to its fair market value. These rules do not apply in the case of the equal division of community property, and the IRS has ruled that this rule does not apply to the partition of jointly held property.[1] The tax treatment of divisions of property between spouses involving other various types of ownership under the different State laws is often unclear and has resulted in much litigation.[2] Several states have amended their property law in an attempt to avoid the result in the *Davis* case.

In addition, under present law, losses are not allowed with respect to the transfer of property between spouses (sec. 267), and capital gains treatment and installment sales reporting are not allowed on the sale or exchange of depreciable property between spouses (secs. 1239 and 453(g)). These rules do not apply to transfers between former spouses.

Issue

The issue is whether the transfer of property between spouses during marriage or transfers incident to divorce should be a taxable event.

Explanation of Provision

The bill would provide that the transfer of property to a spouse incident to a divorce would be treated, for income tax purposes, in the same manner as a gift. Gain or loss would not be recognized to the transferor, and the transferee would receive the property at the transferor's basis (whether the property has appreciated or depreciated in value). A transfer would be treated as incident to a divorce if the transfer occurs within one year after the parties cease to be married or is related to the divorce. This nonrecognition rule would apply whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of li-

[1] See Rev. Rul. 74-347, 1974-2 C.B.26

[2] See e.g., *Commissioner* v. *Collins*, 412 F.2d 211 (10th Cir. 1969); *U.S.* v. *Wallace*, 439 F.2d 757 (8th Cir. 1971); *Commissioner* v. *Wiles*, 499 F.2d 255 (10th Cir. 1974); *U.S.* v. *Imel*, 523 F.2d 853 (10th Cir. 1975); *W. W. McKinney*, 64 T.C. 262 (1975); *U.S.* v. *Bosch*, 590 F.2d 165 (5th Cir. 1979).

abilities, or for other consideration. Thus, uniform Federal income tax consequences would apply to these transfers notwithstanding that the property may be subject to differing state property laws.

In addition, this nonrecognition rule would apply in the case of transfers of property between spouses during marriage.

Where an annuity is transferred, or a beneficial interest in a trust is transferred or created, incident to divorce or separation, the transferee would be entitled to the usual annuity treatment, including recovery of the transferor's investment in the contract (under sec. 72), or the usual treatment as the beneficiary of a trust (by reason of sec. 682), notwithstanding that the annuity payments or payments by the trust qualify as alimony or otherwise discharge a support obligation.[3] The transfer of a life insurance contract to a spouse incident to a divorce or separation generally would no longer result in the proceeds of the policy later being includible in income, since the policy would have a carryover basis and therefore the transfer for value rules (sec. 101(a)(2)) would not apply.

Effective Date

The provision would apply to transfers after the date of enactment of the bill. However, it would not apply to transfers pursuant to instruments in effect before such date unless the parties elect to have these provisions apply.

Revenue Effect

This provision would reduce revenues by less than $5 million annually.

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[3] This rule relates, in part, to amendments made to Code section 71 by section 203 of the bill.

2. Alimony (sec. 203 of the bill and secs. 71 and 215 of the Code)

Present Law

In general

Under present law, payments of alimony pursuant to a decree of divorce or separate maintenance, a written separation agreement or decree for support or maintenance are deductible by the payor spouse and includible in the income of the recipient spouse. The amount of the payment is deductible in computing adjusted gross income and thus is allowable whether or not the payor itemizes his or her deductions.

In order to be treated as alimony, a payment must meet several requirements. First, the payment must be in discharge of a legal obligation imposed upon or incurred by a spouse because of a family or marital relationship. Second, the payment must be imposed under the decree of divorce or separate maintenance or under a written instrument incident to the divorce or separation, made under a written separation agreement, or required under a decree of support or maintenance. Third, the payment must be "periodic." A payment will not qualify as "periodic" if it discharges a principal sum, unless the sum may be paid over a period exceeding 10 years from the date of the divorce or separation decree, instrument or agreement; then the annual amount treated as alimony cannot exceed 10 percent of the principal sum.

Payments which are fixed by the decree or agreement as child support are not treated as alimony and therefore are not deductible by the payor or includible in income of the recipient.[4]

Legislative background

Prior to 1942, there was no statutory provision explicitly dealing with alimony payments. In 1917, the Supreme Court held that, under the provisions of the Income Tax Act of 1913, alimony paid to a divorced wife was not taxable income.[5] From 1917 to 1942, the result in the *Gould* case remained unchanged and alimony was neither includible in the recipient's income nor deductible by the payor.

When tax rates were increased significantly in 1942, Congress recognized that the higher tax rates would intensify the hardship of payment of alimony out of after-tax income. Congress, therefore, enacted provisions in the Revenue Act of 1942 to require that certain alimony payments be included in the recipient spouse's income and to permit the payor spouse to deduct those payments as an itemized deduction. These provisions applied to alimony payments

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[4] *Commissioner* v. *Lester*, 366 U.S. 299 (1961) sets forth rules relating to the designation of amounts as child support rather than alimony.

[5] *Gould* v. *Gould*, 245 U.S. 151 (1917).

made by persons who were divorced or legally separated. In 1954, the alimony provisions were extended to apply to payments made under a decree for support where the parties are physically separated. The Tax Reform Act of 1976 permitted alimony to be deducted in arriving at adjusted gross income so that a taxpayer who does not itemize deductions may nevertheless deduct alimony.

Tax effects

A principal purpose for the present tax treatment of alimony is to relieve the payor of the burden of paying tax on the income which is transferred to the payee spouse as alimony and to impose that burden on the spouse receiving the alimony. In addition to transferring the tax burden, under present law an overall tax savings generally results because the payor is normally in a higher marginal tax bracket than the payee. Because rates for a single taxpayer or head of household are lower than the rates for married persons filing separate returns (upon which the joint return rates are based), two individuals who are divorced and between whom alimony is paid may pay less total tax than they paid prior to marriage or during marriage.

For example, assume that single individuals A and B have earned income of $51,000 and $11,000 (taxable income of $50,000 and $10,000), respectively. As single taxpayers, their respective taxes for 1983 would be $14,738 and $1,121. Their combined tax is $15,859. If A and B were married for 1983, their joint return tax liability would be $15,574.[6] If A and B are divorced for 1983 and A pays B $20,000 alimony, they each would have a liability as a single taxpayer of $6,477. Their combined tax would be $12,954.

Issues

The issues include—

(1) whether alimony payments should be deductible by the payor spouse and includible in income by the recipient spouse; and

(2) whether the definition of alimony, for income tax purposes, should be amended to provide uniform rules without regard to State law support requirements.

Explanation of Provision

Under the bill, alimony payments would continue to be deductible by the payor spouse and includible in income by the recipient spouse. However, the bill would amend the definition of alimony. The requirement that the payment must be made on account of a marital obligation imposed under local law would be repealed and the present law requirement that the payment be "periodic" would not be retained.

Under the bill, an alimony payment must meet several requirements. The payment must be made in cash and received by the payor's spouse (or former spouse). A payment could also qualify as

[6] This is based on $58,900 taxable income ($62,000 gross income, $1,100 marriage penalty deduction (under sec. 221) and a $2,000 deduction for personal exemptions. This example assumes neither party itemizes deductions.

alimony (by reason of constructive receipt), for example, where a cash payment is made to a third party for the benefit of the payee spouse. As under present law, an alimony payment must be made under a decree of divorce or separate maintenance or under a written instrument incident to the divorce, a written separation agreement, or a decree requiring support or maintenance payments.

The parties could not be members of the same household at the time the payment is made. However, under the bill, alimony treatment is not to be denied for any payment made shortly before one spouse departs from the marital household.

A payment would qualify as alimony only if the payor (or any person making a payment on behalf of the payor) has no liability to make any such payment for any period following the death of the payee spouse. A provision for a substitute payment, such as an additional amount to be paid as child support after the death of the payee spouse would prevent a corresponding amount of the payment to the payee spouse from qualifying as alimony. Amounts payable under a life insurance contract on the life of the payee spouse would not be treated as a liability which would affect the status of other payments made by the payor spouse.

In order to prevent a one-time lump-sum payment (or similar payment) from being disguised as alimony, the bill would require that, except in the case of support decrees, it be reasonable to expect that at least one-half of the alimony payments be made more than one calendar year after the first payment is made.

Finally, no payment would qualify as alimony if the payment is for property transferred from the payee spouse. This rule would not apply to the extent the payments are for the relinquishment of the payee spouse's marital rights or support rights under local law. In applying these rules, the fact that the payee spouse has otherwise made a net transfer of assets to the payor spouse would indicate that payments are for the transfer of property.

The parties could, by clearly designating in a written agreement, provide that otherwise qualifying payments would not be treated as alimony for Federal income tax purposes.

The bill provides that the Internal Revenue Service may require the payor spouse to furnish on his or her tax return the name and social security number of the payee spouse, and that the payee must furnish that number to the payor. A $50 penalty could be assessed against any party for failure to comply with the applicable requirement.

As under present law, amounts fixed as child support would not be treated as alimony.

Effective Date

These provisions would generally apply to divorce or support decrees and agreements executed after 1983. The provision would also apply with respect to the modification of a prior instrument where the modified instrument expressly so provides.

Revenue Effect

These provisions would increase revenues by less than $5 million per year.

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3. Dependency Exemption (sec. 204 of the bill and sec. 152(e) of the Code)

Present Law

Under present law, a $1,000 deduction for a dependency exemption is generally allowed for each dependent child of the taxpayer. Normally, in order to qualify as a taxpayer's dependent, a child must have over half of his or her support for the year furnished by the taxpayer.

In the case of children of divorced or separated parents, a special rule applies in determining which parent provided over half of the support (sec. 152(e)).

In general, a divorced or separated parent who has custody of a child for the greater part of the year (the custodial parent) may claim the dependency exemption for the child if the parents together have custody of the child for more than one-half of the year and provide more than one-half of the child's support. A special rule provides that the noncustodial parent, rather than the custodial parent, may claim the dependency exemption if (1) a decree or written agreement allocates the exemption to the noncustodial parent and the noncustodial parent pays at least $600 for the support of the child during the calendar year; or (2) the noncustodial parent provides at least $1,200 for the support of the child during the calendar year and the custodial parent does not clearly establish that he or she provided more for the support of the child than did the non-custodial parent. None of these rules apply in the case where the dependency exemption has been allocated under the special rules applying to multiple support where no one person contributed over half the support of an individual.

In addition to the dependency exemption, the deduction for medical expenses, the treatment of a parent as qualifying for either single rates or head of household rates, the earned income credit, and the credit for household and dependent care services are, in part, determined by reference to whether the parent furnishes over half of the support of a child.

Issues

The issues include—

(1) whether divorced or separated parents should be allowed to choose which parent gets the dependency exemption for their child; and

(2) whether a minimum support requirement should be retained in order for a noncustodial parent to be able to claim a dependency exemption for a child.

Explanation of Provision

Under the bill, as under present law, the parent having custody of a child for the greater portion of the year (the custodial parent) would generally be treated as having provided more than one-half of the child's support and therefor be entitled to receive the dependency exemption. This rule also would apply to parents not living together during the last 6 months of the calendar year, as well as those divorced or separated under a separation agreement. The bill would provide three exceptions to the general rule. First, the custodial parent could release his or her claim to the exemption for the year to the noncustodial parent. For this exception to apply, the custodial parent would have to sign a written declaration that he or she will not claim the child as a dependent for the year, and the noncustodial parent would have to attach the written declaration to his or her tax return.

Next, as under present law, the general rule would not apply in the case of multiple support agreements. Finally, an exception would be provided to continue existing law for certain decrees or agreements which are executed before January 1, 1984, and under which the custodial parent had agreed to release his or her claim to the dependency exemption to the noncustodial parent. Thus, if such an agreement exists, the noncustodial parent could claim the dependency exemption if he or she provides at least $600 for the support of the child during the year.

For purposes of the medical expense deduction, any child subject to the rules described above would be treated as a dependent of both parents. Thus, a parent could deduct medical expenses paid for the child even though a dependency exemption for the child may be allowed to the other parent.

Under the bill, certain provisions are amended to provide consistent rules among various inter-related sections concerning the family status of individuals living apart. The basic rule adopted is that in the present child and dependent care credit (sec. 44A). An amendment would be made to sec. 143(6) to provide that for an otherwise married individual living with a child to be considered not married, his or her spouse could not be a member of the household for the last six months of the year, rather than the entire year as under present law. The definition of head of household status (sec. 2) would be amended to provide that the household must be maintained as the principal place of abode for the child for more than one-half of the year, rather than for the entire year as under present law.

Further, the definitions of marital and head of household status, the earned income credit (sec. 43), and the child and dependent care credit (sec. 44A) would be amended to provide that any custodial parent who releases a claim to a dependency exemption under the above rules would be treated as entitled to the dependency exemption for the purposes of these sections. Thus, such a custodial parent could be eligible for unmarried status, head of household status, or the credits if the other conditions of those provisions are met.

Effective Date

These provisions would be effective for taxable years beginning after December 31, 1983.

Revenue Effect

These provisions would have a negligible revenue effect.

4. Innocent Spouse Relieved of Liability in Certain Cases (sec. 205 of the bill and secs. 66 and 6013 of the Code)

Present Law

Tax liability of spouses who file joint returns

In general, a husband and wife are permitted to file a joint income tax return, even if one spouse has no income or deductions. Spouses who file a joint return have joint and several liability for the tax computed on their aggregate income.

Under limited circumstances, a spouse may be relieved of liability for tax (including interest and penalties) on a joint return (sec. 6013(e)). The application of this so-called innocent spouse rule is limited to cases in which the liability for tax results from an omission from gross income that exceeds 25 percent of the gross income stated in the return. In such cases, the person seeking relief must establish that the unreported income is attributable to the other spouse, and that he or she had no knowledge of (or reason to know of) the omission. The determination of the spouse to whom the unreported income is attributable is made without regard to community property laws. In addition, taking into account whether the innocent spouse significantly benefitted from the omission from income, a determination is required as to whether it would be inequitable to hold such spouse liable for the tax. In determining whether there was an omission of more than 25 percent of the income disclosed on the return, amounts as to which adequate information was provided on the return are not taken into account.

Community income of spouses who live apart

In general, if a husband and wife file separate returns, each is required to report one-half of the income attributable to community property under State law. However, if certain requirements are met, relief from tax liability is provided for an abandoned spouse (sec. 66). To qualify, a couple must be married at some time during the calendar year, but live apart during the entire calendar year. The spouse seeking relief must not have filed a joint return, and one or both of the spouses must have earned income (*i.e.*, income attributable to the performance of personal services) that constitutes community income. In addition, no portion of the earned income (other than *de minimis* amounts) may have been transferred (directly or indirectly) between the spouses before the close of the calendar year.

If all of the above requirements are met, the applicable community property law with respect to certain types of income will be disregarded for Federal income tax purposes. Under special allocation rules (1) earned income (other than income from a trade or business or a partner's distributive share of a partnership's income) is treated as the income of the spouse who rendered the personal services, (2) income derived from a trade or business (other than that carried on by a partnership) is treated as the income of the spouse who carries on the trade or business, unless the other spouse exercises substantially all of the management and control of such trade or business, and (3) a partner's distributive share of a partnership's income is treated as the income of the partner. All other community income is characterized in accordance with the applicable community property laws.

Issue

The issue is whether the innocent spouse rules should be modified so as to provide relief from income tax liability in additional situations where the failure to grant relief would be inequitable.

Explanation of Provision

The bill would liberalize the innocent spouse joint return relief provision by expanding the circumstances in which relief may be granted. The bill would also provide additional relief to a spouse who is liable for tax on community income that is attributable to the other spouse.

Joint return liability of innocent spouse

Under the bill, the innocent spouse rule (sec. 6013(e)) would apply to cases in which the tax liability results from a substantial understatement of tax that is attributable to grossly erroneous items (including claims for deductions or credits, as well as omitted income) of one spouse. Grossly erroneous items would include any item of income that is omitted from gross income, regardless of the basis for omission. A claim for deduction or credit would be treated as a grossly erroneous item only if the claim had no basis in law or fact. The bill would define a substantial understatement as any understatement that exceeds 10 percent of the tax required to be shown on the return or $500, whichever is less. As under present law, relief may be granted only where it would be inequitable to hold the innocent spouse liable.

In applying these rules, community property laws would continue to be disregarded in determining to whom an item is attributable. The bill would not specifically require that the determination of whether it would be inequitable to hold the innocent spouse liable include consideration of whether such spouse benefitted from the erroneous item. The omission from income determination may apply notwithstanding that adequate information about the erroneous items was provided on the return.

Relief for separate return liability attributable to community income

The bill would provide a new rule relating to the treatment of certain community income. This provision would apply in cases where a spouse fails to include in gross income an item of community income that would be treated as the income of the other spouse if the special allocation rules applicable under the community-income provision of present law had applied. This rule would apply only where the spouse seeking relief did not file a joint return for the taxable year and establishes that he or she had no knowledge of (or reason to know of) the item of community income. The bill would also require that a determination be made that it would be inequitable to include the unreported income in the gross income of the spouse seeking relief.

If all of the above requirements are met, then the unreported community income would be included in the gross income of the spouse to whom the income is attributable under the special rules of allocation and not the income of the innocent spouse.

Effective Date

The bill would apply to all taxable years to which the Internal Revenue Code of 1954 applies. Further, the bill provides that corresponding provisions would be deemed to be included in the Internal Revenue Code of 1939, and would apply to all taxable years to which the 1939 Code applied. It is understood that the effective date provided in the bill is not intended to open a year that has been closed by the statute of limitations, res judicata, or otherwise.

Revenue Effect

This provision would have a negligble revenue effect.

5. Estate Tax Treatment of Certain Property Settlements (sec. 206 of the bill and sec. 2043 of the Code)

Present Law

Under present law, transfers of property (other than certain terminable interests) between spouses are not subject to estate or gift taxes.

With several exceptions, transfers of property to a former spouse in satisfaction of marital or property rights are taxable gifts. A transfer of property between former spouses is not subject to gift tax if the transfer is pursuant to a written agreement entered into not more than two years prior to divorce and is in settlement of marital or property rights or to provide a reasonable allowance for the support of minor children (sec. 2516). In addition, property transfers ordered by a divorce court having the power to order the disposition of the property are not taxable gifts.[7] Finally, the transfer of property in discharge of a former spouse's right to support is not a taxable gift.

For estate tax purposes, a claim of a former spouse based on the release of marital or property rights is not deductible in computing the taxable estate unless the claim is based on a court decree where the court had the power to determine the marital or property rights of the spouse.[8] Also, a claim based on the release of support rights is deductible.

Issue

The issue is whether the estate tax treatment with respect to certain property settlements between spouses should be conformed to the present gift tax treatment.

Explanation of Provision

The bill would allow an estate tax deduction for claims arising under a written agreement in settlement of marital or property rights where the agreement would have qualified such transfers as non-taxable for gift tax purposes (under sec. 2516). Thus, where the transferor dies prior to completing the transfers under the written agreement, no estate tax will be imposed with respect to the property transferred by the estate.

Effective Date

This provision would apply in the case of decedents dying after the date of enactment of the bill.

Revenue Effect

This provision would have a negligible revenue effect.

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[7] *Harris* v. *Comm'r.*, 340 U.S. 106 (1950).
[8] Id.

C. Revision of At-Risk Rules for the Investment Tax Credit (Title III of the bill and sec. 46 of the Code)

Present Law

In general

The Economic Recovery Tax Act of 1981 provided that the allowance of the investment tax credit is subject to an at-risk limitation. The limitation applies to the same activities and the same category of taxpayers that are subject to the at-risk loss limitation rules (sec. 465). Thus, the investment credit at-risk rules apply to individuals and closely held corporations that are engaged in a trade or business or other income-producing activity (other than real estate and certain corporate leasing).

The investment tax credit is not allowed for amounts invested in qualifying property to the extent the invested amounts are not at risk (within the meaning of sec. 465(b)). Amounts generally are not considered at risk if (1) the taxpayer is protected against the loss of the invested amount, (2) the amount was borrowed and the taxpayer is not personally liable for repayment of the debt, (3) the lender has an interest (other than as a creditor) in the business activity in which the property is used, or (4) the lender is a related party to the taxpayer.

Present law provides two exceptions to the investment credit at-risk rules. Under the first exception, amounts borrowed (other than convertible debt) with respect to qualifying investment tax credit property no later than the taxable year the property is placed in service generally will be considered at risk if (1) the taxpayer at all times has a minimum 20-percent at-risk investment in the property (determined without regard to the exception) and (2) the amount borrowed is owed to either a qualified lender or a Federal, State, or local government. Qualified lenders include banks, savings and loan institutions, credit unions, insurance companies, qualified pension trusts, and other persons actively and regularly engaged in the business of lending money.

For the qualified lender exception to apply, the lender must not be related to the taxpayer. In addition, the qualified lender may not be a person who receives a fee with respect to the taxpayer's investment in the qualifying property (e.g., a promoter) or a person related to such person. The exception also does not apply if the taxpayer has acquired the property from (1) the qualified lender (or a person related to the lender) or (2) a person related to the taxpayer.

Under the second exception, a safe harbor rule is provided for certain level payment loans related to qualified energy property.

In the case of a partnership, or S corporation, the investment credit at-risk rules apply at the partner or shareholder level.[9] Thus, the calculation of amounts at-risk is made by each partner or shareholder to whom the at-risk rules apply. Amounts for which a partnership or S corporation are considered at risk under the qualified lender exception are allocated among the partners or shareholders according to the rules for allocation of the investment tax credit. However, this allocation rule does not apply for purposes of determining whether each partner or shareholder has a minimum 20 percent at-risk investment in the property. Thus, to benefit from the qualified lender exception, each partner or shareholder must have an individual 20 percent at-risk investment in the property, determined under the general rule. Determinations of whether the taxpayer has acquired property or borrowed money from a related person are likewise made with respect to each partner or shareholder.

The at-risk limitation on the investment tax credit applies to property placed in service on or after February 19, 1981. An exception is provided for property placed in service on or after that date if the property was acquired by the taxpayer under a binding contract entered into before February 19, 1981.

Legislative background

The at-risk loss limitation rule was first adopted by the Congress in 1976, and later expanded in 1978, in order to prevent taxpayers from reducing their tax liability on income from other sources through the acquisition of an interest in a tax shelter activity. The investment tax credit at-risk rule was adopted for similar reasons in 1981.

The at-risk rules generally limit a taxpayer's tax benefits to the benefits attributable to funds which the taxpayer has personally invested in an activity (in the case of the loss limitation rule) or a property (in the case of the investment tax credit rule), including funds which the taxpayer borrowed and is personally liable to repay. In the case of property which is seller-financed (or financed by a party related to the seller), this reduces the incentive for the parties to inflate the purchase price in order to give the purchaser additional tax deductions (for depreciation or accrued interest) or an inflated investment tax credit. In these situations, the buyer may be unconcerned about the higher price since the property simply may be repossessed by the seller after the buyer has benefitted from the tax deductions or credits. The at-risk rules also prevent tax benefits from accruing to a purchaser who has no real equity in the property because the property's value is, or may become, less than the face amount of the nonrecourse loan. In these situations, the purchaser may receive tax benefits without bearing the economic burden of any corresponding decline in the property's value. In addition, the at-risk rules reduce the situations in which taxpayers may fail to recapture income or credits from the disposition of tax shelter property since, under the at-risk

[9] These provisions no longer apply at the corporate level as a result of an amendment made by the Subchapter S Revision Act of 1982 (P.L. 97-354).

rules, the deductions would not have been allowed in the first instance.

Issues

The issues include—

(1) whether the at-risk rules for the investment tax credit should be amended to reduce the credit base of investment tax credit property by the amount of nonrecourse financing (other than qualified commercial financing) with respect to the property, rather than applying the loss deduction at-risk rules to the investment tax credit; and

(2) whether amounts borrowed recourse from commercial lenders by an S corporation to acquire property for use in its active trade or business should be allocated among the S shareholders, so that the shareholders may claim the credit based on the corporate financing.

Explanation of Provision

Under the bill, the investment tax credit at-risk rules would be revised. Instead of applying the section 465 at-risk rules directly, the bill would reduce the credit base for the investment tax credit by the amount of nonrecourse financing, other than certain commercial financing, with respect to a property. However, the general concepts of the at-risk rules would continue to apply.

Under the bill, the basis (or cost, in the case of used property) of property would be reduced by the nonrecourse financing, other than qualified commercial financing, with respect to the property for purposes of determining the investment credit. The provision would apply to the same taxpayers and the same activities that are currently subject to the at-risk rules. Nonrecourse financing would include amounts with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar agreements. Except to the extent otherwise provided by regulations, nonrecourse financing would also include amounts borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used (or a person related to such person).

The bill would provide an exception for qualified commercial financing similar to that under present law. Qualified commercial financing would include financing (other than convertible debt) provided or guaranteed by any Federal, State or local government or borrowed from a qualified person. Qualified persons would include any person actively and regularly engaged in the business of lending money. However, qualified persons would not include (1) any person related to the taxpayer, (2) any person from which the taxpayer acquired the property (or a person related to such person), or (3) any person who receives a fee (e.g., a promoter) with respect to the taxpayer's investment in the property (or a person related to such person).

In order for the exception for qualified commercial financing to apply, the amount of nonrecourse financing with respect to the property could not exceed 80 percent of the credit base. Additionally, the exception would not apply where property was acquired by the taxpayer from a related person.

The bill would adopt the definition of related person contained in section 168(e)(4) (relating to accelerated cost recovery). Under this rule, related persons generally include family members, fiduciaries and corporations (or partnerships) in which a person has at least a 10 percent equity interest.

The present law safe harbor rule for certain energy property would be continued under the bill.

The bill would provide that, in the case of partnerships or S corporations, the determination of whether financing is nonqualified nonrecourse financing is to be made at the partner or shareholder level. A special rule, however, would be provided for financing provided by a qualified commercial lender to an S corporation. Under this rule, an allocable share of such financing would be treated as recourse to an S shareholder if the financing is recourse at the corporate level and is provided with respect to qualified business property. Qualified business property would include property used by the S corporation in an active trade or business which during the entire taxable year has at least 3 full-time employees substantially all of whose services are directly related to the business. Qualified property would not include master sound recordings or other tangible or intangible assets associated with literary, artistic or musical properties. The amount of any partner's or shareholder's allocable share of any financing would be determined according to the rules for allocation of the investment tax credit.

The bill would include rules for the treatment of subsequent increases and decreases in nonqualified nonrecourse financing. These provisions would generally be consistent with the treatment of changes in the at-risk investment rules under present law. The bill would also include a number of technical amendments to the rules concerning qualified energy property.

Effective Date

The bill generally would apply to property placed in service after the date of enactment in taxable years ending after such date. However, at the election of the taxpayer, the provisions of the bill would apply as if included in the Economic Recovery Tax Act of 1981 (ERTA). Any such election would apply to all property of the taxpayer to which the ERTA rules applied.

Revenue Effect

The provision would have a negligible revenue effect.

D. Estate Tax Revisions

1. Permanent Rules for Reforming Governing Instruments Creating Charitable Remainder Trusts and Other Charitable Interests (sec. 401 of the bill and sec. 2055 of the Code)

Present Law

The Tax Reform Act of 1969 imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., part charitable and part noncharitable). In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must either be a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined at least annually).

Present law also allows the governing instruments of charitable split-interest trusts which were executed before December 31, 1979, to be amended to conform the governing instruments to the new requirements if the amendment is completed, or judicial proceedings necessary to amend the governing instrument are begun, by December 31, 1981.

Issues

The issues include—

(1) Should the ability to amend the governing instruments of charitable split-interest trusts to conform to the 1969 Act requirements be made permanent?

(2) If so, should the ability to amend be conditioned upon a good faith effort to comply with the 1969 Act rules?

(3) Should restrictions be placed on the amendment procedure to insure that beneficiaries of trusts with defective instruments are not in significantly better position than beneficiaries of trusts with nondefective instruments?

Explanation of Provision

In substance, the bill would provide a permanent rule permitting reformation of governing instruments of charitable split interest trusts which do not meet the requirements of the 1969 Act rules. Such reformations would be allowed where the instrument evidences an intent to comply with the 1969 Act rules and the actuarial values and durations of the charitable and noncharitable interests in the trust generally remain the same before and after the reformation.

Under the bill, an income, gift, or estate tax charitable deduction is allowed for property passing to charity in respect of any qualified reformation. A qualified reformation is a change in the governing instrument of a trust which changes a reformable interest into a qualified interest if two conditions are met. Under the first condition, the difference between the actuarial values of the charitable interests of the reformed trust and the unreformed trust cannot exceed 5 percent of the actuarial value of the charitable interest before the reformation. The second condition limits changes in the length of the charitable and noncharitable interests in the trust. In the case of a charitable remainder trust, the noncharitable interests must terminate at the same time both before and after the reformation. An exception is made to this rule to permit a noncharitable interest which is for a term of years in excess of 20 years to be reduced to 20 years.[10] In the case of other interests (e.g., charitable lead trusts), the charitable interest must be the same duration under both the reformed and unreformed trusts.

The charitable interest is a reformable interest if a deduction would have been allowable for that interest under the rules applicable to split interest transfers prior to the Tax Reform Act of 1969 and, in the case of wills executed after December 31, 1978, the will evidenced an intent to comply with the 1969 Act rules. The will evidences such an intent only if all payments to noncharitable beneficiaries of a charitable remainder trust are expressed either as a specified dollar amount or as a fixed percentage of the fair market value of the trust property.

The bill would treat as a reformation the death of all "income" beneficiaries of a charitable remainder trust before the filing date of the return. In such a case, a deduction would be allowed for the actuarial value of the remainder interest as if the trust instrument had been reformed.

Effective Date

This provision would be effective with respect to trust reformations made after December 31, 1981.

Revenue Effect

This provision would reduce revenues by less than $5 million per year.

[10] In such a case, the amount of the annual noncharitable distributions must be increased to insure that the actuarial value of the charitable and noncharitable interests are the same before and after the reformation.

2. Alternate Valuation Date Election (secs. 402 and 403 of the bill and sec. 2032 of the Code)

Present Law

Under present law, the value of property included in the decedent's gross estate for Federal estate tax purposes generally is determined on the date of the decedent's death. However, the executor of the decedent's estate may elect to have the value of all property included in the gross estate determined as of the alternate valuation date, which generally is the date six months after the date of the decedent's death. The election to use the alternate valuation date may be made only on a timely filed Federal estate tax return. The election may be made whether or not the Federal estate tax liability of the estate is reduced.

Also under present law, the basis of property acquired from a decedent in the hands of the decedent's estate or his heirs generally is the value of that property determined for Federal estate tax purposes (i.e., basis is "stepped up" or "stepped down" to fair market value at death or alternate valuation date).

Where property has appreciated in value since the date of the decedent's death, it is possible under present law to elect the alternate valuation date to increase the income tax basis of the property even though there is no additional Federal estate tax arising from the election. No estate tax may be due either because the estate is not sufficiently high in value or because the appreciated property is transferred to the decedent's surviving spouse.

Issues

The issues include—

(1) Whether use of the election for the alternate valuation date should be available to increase the income tax basis of inherited property where there is no reduction in the Federal estate tax from making the election?

(2) Whether the election to use the alternate valuation date must be made on a timely filed Federal estate tax return or should it also be available on a late filed return?

Explanation of Provision

The bill would provide that the election to use the alternate valuation date may be made only where both the total value of all property in the gross estate and the Federal estate tax liability of the estate are both reduced.

The bill would also provide that the election to use the alternate valuation date may be made on the first estate tax filed (whether filed timely or late).

Effective Date

These provisions would be effective with respect to decedents dying after the date of enactment of the bill.

Revenue Effect

These provisions would have no revenue effect.

E. Foreign Tax Provisions (Title V of the Bill)

1. Resident aliens (sec. 501 of the bill and sec. 7701(b) of the Code)

Present Law

Resident aliens are subject to U.S. income tax on their worldwide income at the regular graduated rates. Nonresident aliens are subject to U.S. tax only to the extent their income is from U.S. sources or is effectively connected with the conduct of a trade or business within the United States. Certain passive U.S. source income of nonresident aliens is subject to tax at a flat 30 percent rate (unless the rate is reduced by treaty).

The Internal Revenue Code does not define the terms "resident alien" or "nonresident alien." Treasury Regulations generally apply a subjective test and define the terms on the basis of the alien's intentions with regard to the length and nature of his or her stay (Treas. Reg. Sec. 1.871-2). In general, under the regulations, residence depends on whether an alien is "a mere transient or sojourner" in the United States. Living in the United States with no definite intention as to the length and nature of his or her stay makes an alien a resident under the regulations. A visa that limits the alien's stay to a definite period makes him or her a nonresident absent "exceptional circumstances." An individual may be a resident of more than one country.

In certain cases, individuals who earn U.S. source income may seek to minimize their U.S. tax by claiming that they are taxable on a fiscal year basis rather than a calendar year basis and thus allocating their U.S. income into more than one fiscal year if such an allocation is beneficial (*e.g.*, if they have income for only a part of some fiscal year).

Issues

The issues raised by the proposed definition of resident alien include—

(1) whether an objective definition of residence is approprate or whether it is better to maintain the present subjective standard;

(2) to what extent certain classes of individuals (such as diplomats, students, teachers, trainees, and their immediate families, or others) should be excluded from residence status;

(3) whether residence—or seeking residence—for immigration purposes should determine residence for tax purposes;

(4) Whether there should be special rules for taxpayers seeking to be subject to tax on a taxable year other than the calendar year; and

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(5) whether presence for some period of time should subject an alien to tax on worldwide income including tax on the income of controlled foreign entities, or whether a two-tier definition of residence (exempting some aliens that are generally U.S. residents from U.S. rules that subject certain foreign income to tax) might be appropriate.

Explanation of Provision

The bill would provide a definition of resident alien for U.S. tax purposes. Aliens who do not meet this definition would be nonresident aliens. For income tax purposes, an individual would be considered a resident for any calendar year if the individual:

(1) is a lawful permanent resident of the U.S. at any time during the calendar year (the "green card test");

(2) has an application for an immigrant visa pending at any time during the year and is physically present in the U.S. during at least 60 days during the year; or

(3) is present in the United States for a substantial period of time—as many as 183 days during a 3-year period weighted toward the present year (the "substantial presence test").[11]

If an individual were present in the United States for fewer than 183 days during the year, and if the individual established that he or she had a closer connection with a foreign country than with the United States and a tax home in that country for the year, the individual would not be subject to tax as a resident on account of the substantial presence test. If an individual were present for as many as 183 days, this closer connections/tax home exception would not apply.

In addition, certain individuals (foreign government-related individuals, teachers, trainees, and students) that meet the substantial presence test would generally be nonresident aliens unless the facts and circumstances indicate that they intend to reside permanently in the United States.

The bill would define the term "foreign government-related individual" to mean any individual temporarily admitted into the United States by reason of (1) diplomatic status, or a visa which the Secretary of the Treasury (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status; (2) being a full-time employee of an international organization; or (3) being a member of the immediate family of such a diplomat or international organization employee.

The term "teacher or trainee" would mean any individual who is temporarily admitted into the United States under subparagraph (J) of section 101(15) of the Immigration and Nationality Act[12]

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[11] This substantial presence test would compare 183 days to the sum of (1) the days present during the current year, (2) two-thirds of the days present during the preceding year, and (3) one-third of the days present during the second preceding year.

[12] Subparagraph (J) of section 101(15) of the Immigration and Nationality Act now applies to "an alien having a residence in a foreign country which he has no intention of abandoning who is a bona fide student, scholar, trainee, teacher, professor, research assistant, specialist, or leader in a field of specialized knowledge or skill, or other person of similar description, who is coming temporarily to the United States as a participant in a program designated by the Secretary of State, for the purpose of teaching, instructing or lecturing, studying, observing, conducting research, consulting, demonstrating special skills, or receiving training and who, if he is

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(other than as a student), and who substantially complies with the requirements for being so admitted.

A "student" would be any individual who is temporarily admitted into the United States either under subparagraph (F) of section 101(15) of the Immigration and Nationality Act,[13] or as a student under subparagraph (J) of that section, and who substantially complies with the requirements for being so admitted.

An individual could not be exempt from the substantial presence test as a teacher or trainee if he or she had been exempt as a teacher, trainee, or student for any two of the six preceding years. An individual could not be exempt from the substantial presence test as a student if he or she had been exempt as a teacher, trainee, or student for five previous calendar years, unless that individual established to the satisfaction of the Secretary that he or she did not intend to reside permanently in the United States and that he or she substantially complied with the requirements of the student visa providing for the individual's temporary admission into the United States.

The bill would define lawful permanent resident to mean an individual who has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, if such status has not been revoked. An "immigrant visa" would be any visa entitling an individual to be lawfully admitted into the United States for permanent residence.

Presence during a day would be presence at any time during the day. Regular commuters to employment or self employment in the United States from a place of residence in Canada or Mexico would not be treated as present in the United States on days when they so commuted.

The Secretary of the Treasury would be authorized to require aliens who claim exemption from the substantial presence test (whether under the closer connection/tax home exception or the exempt individual exception) to file statements explaining the basis for their exemption.

A taxpayer who has not established a taxable year for any prior period would be taxed on a calendar year basis. A taxpayer who establishes a fiscal year would determine residence on a calendar year basis, and would be subject to tax as a resident for any portion of his fiscal year within a calendar year of residence.

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coming to the United States to participate in a program under which he will receive graduate medical education or training, also meets the requirements of section 1182(j) of this title, and the alien spouse and minor children of any such alien if accompanying him or following to join him." The definition for purposes of this tax legislation would change from time to time as the definition in the Immigration and Nationality Act changed.

[13] Subparagraph (F) of section 101(15) of the Immigration and Nationality Act now applies to "(i) an alien having a residence in a foreign country which he has no intention of abandoning, who is a bona fide student qualified to pursue a full course of study and who seeks to enter the United States temporarily and solely for the purpose of pursuing such a course of study at a college, university, seminary, conservatory, academic high school, elementary school, or other academic institution or in a language training program in the United States, particularly designated by him and approved by the Attorney General after consultation with the Secretary of Education, which institution or place of study shall have agreed to report to the Attorney General the termination of attendance of each nonimmigrant student, and if any such institution of learning or place of study fails to make reports promptly the approval shall be withdrawn and (ii) the alien spouse and minor children of any such alien if accompanying him or following to join him." The definition for purposes of this tax legislation would change from time to time as the definition in the Immigration and Nationality Act changed.

Effective Date

These provisions would apply to taxable years beginning after December 31, 1983.

Revenue Effect

These provisions would result in a revenue gain of approximately $5 million in fiscal year 1984, and of approximately $10 million for each fiscal year during the period 1985-1988.

2. Treatment of Community Property Income of Nonresident Aliens (sec. 502 of the bill and sec. 879 of the Code)

Present Law

A graduated income tax like that of the United States imposes less tax on a given amount of income if the income belongs to more than one person. Therefore, when married taxpayers split their income, they generally reduce their combined tax liability. Nonresident aliens are subject to U.S. tax at the regular graduated rates on income that is effectively connected with the conduct of a trade or businss within the United States. If one member of a married couple is a U.S. citizen or resident while the other member is a nonresident alien, the earned income of one spouse, the trade or business income of one spouse, the partnership share of trade or business income of one spouse, or the community income from the separate property of one spouse is generally treated as the income of that spouse. Therefore, if that income is effectively connected income, the couple generally may not split that income for U.S. tax purposes by use of community property laws. However, if both members of the couple are nonresident aliens from a community property country, they may be able to split the effectively connected income of one spouse to reduce their U.S. tax liability. A comparable couple from a common law country cannot split income in this way.

Issue

The issue is whether the U.S. taxation of married nonresident aliens should depend on the martial property laws of their home country.

Explanation of Provision

The bill would provide that, for U.S. income tax purposes, a married couple both of whom are nonresident alien individuals would treat the earned income of one spouse, the trade or business income of one spouse, the partnership share of trade or business income of one spouse, or the community income from the separate property of one spouse as the income of that spouse, regardless of any community property laws. That spouse would be subject to U.S. tax at the regular graduated rates when such income is effectively connected with the conduct of a U.S. trade or business.

Effective Date

This provision would apply to taxable years beginning after December 31, 1983.

Revenue Effect

This provision would result in a revenue gain of less than $5 million for each of the fiscal years 1984-1988.

3. Foreign Personal Holding Company Attribution Rules (sec. 503 of the bill and secs. 551 and 554 of the Code)

Present Law

The foreign personal holding company rules designed to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation that has primarily foreign personal holding company income (passive income such as dividends, interest, royalties, and rents (if rental income does not amount to 50 percent of gross income)), that corporation will be a foreign personal holding company. In that case, the foreign corporation's U.S. shareholders, including U.S. citizens, residents and corporations, are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income. That is, only individuals count in the ultimate determination of foreign personal holding company status, but persons other than individuals may be subject to foreign personal holding company tax.

Family attribution for characterization as a foreign personal holding company

The foreign personal holding company provisions contain the constructive ownership rules that determine whether a foreign corporation is more than 50 percent owned by five or fewer United States citizens or residents. These rules treat an individual as owning stock owned, directly or indirectly, by or for his or her partners, brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. One case, however, casts doubt on the operation of these constructive ownership rules when nonresident aliens are the only family members who own stock in a foreign corporation.[14]

These constructive ownership rules also apply to deem income to be foreign personal holding company income in two cases: (1) when a foreign corporation has contracted to furnish personal services that an individual who owns, directly or indirectly, 25 percent or more in value of the outstanding stock of the corporation has performed, is to perform, or may be designated to perform; and (2) when an individual who owns, directly or indirectly, 25 percent or more in value of the outstanding stock of the corporation is entitled to use corporate property and when the corporation in any

[14] In *Estate of Nettie S. Miller v. Commissioner*, 43 T.C. 760 (1965), nonacq., 1966-1 C.B. 4, two Canadian sisters owned over half the stock of a Canadian corporation. A divided Tax Court, despite the language of the statute, declined to attribute their stock to their brother, a U.S. citizen and resident, who owned none of the stock. Therefore, the corporation was not a foreign personal holding company, so its U.S. shareholders, who were unrelated to the Canadian sisters, were not subject to tax.

way receives compensation for use of that property. This latter rule prevents foreign corporations from avoiding foreign personal holding company status by generating what appears to be large amounts of rental income.

Income inclusion through foreign entity

Shareholders in a foreign personal holding company who are U.S. citizens or residents, U.S. corporations, U.S. partnerships, or estates and trusts (other than estates and trusts whose gross income includes only income from sources within the United States)[15] must include their share of undistributed foreign personal holding company income in their gross income. These shareholders are called "United States shareholders". If a foreign personal holding company is a shareholder in another foreign personal holding company, the first company includes in its gross income, as a dividend, its share of the undistributed foreign personal holding company income of the second foreign personal holding company. Interposition of a foreign partnership, a foreign corporation other than a foreign personal holding company, an estate or a trust (other than an estate or trust whose gross income includes only income from sources within the United States) between a taxpayer and a foreign personal holding company, however, arguably may allow avoidance of the foreign personal holding company rules. Although stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by its shareholders, partners, or beneficiaries for the purpose of determining whether a corporation is a foreign personal holding company, taxpayers take the position that these tracing rules do not necessarily apply to impose a tax on the ultimate owners of a foreign personal holding company.

Issues

The issues include—

(1) whether there should be attribution of stock to a U.S. individual from his nonresident blood relatives for the purpose of determining whether a foreign corporation is a foreign personal holding company; and

(2) whether it is appropriate to trace ownership through various foreign entities to reach foreign personal holding company income.

Explanation of Provisions

Family attribution for characterization as a foreign personal holding company

The bill would repeal, for the purpose of determining whether five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation, attribute ownership of stock actually owned by a nonresi-

[15] This excluded category of estates and trusts corresponds generally to the definition of "foreign estate or trust" in Internal Revenue Code section 7701(a)(31). Therefore, in general, estates or trusts that are United States persons are subject to the same treatment as U.S. citizens or corporations.

dent alien to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants. There would nonetheless be, for that purpose, attribution of ownership of stock actually owned by a nonresident alien to the alien's U.S. spouse and partners. This attribution would occur even when the U.S. spouse or partner owned no stock in the foreign corporation. The bill would not affect the current attribution rules that operate to treat certain income from personal services and income from certain use of corporate property as foreign personal holding company income.

Income inclusion through foreign entity

The bill would add a tracing rule to prevent taxpayers from interposing foreign corporations (other than foreign personal holding companies), foreign partnerships, estates or trusts whose gross income includes only income from sources within the United States, or other entities between themselves and the foreign corporation to avoid the foreign personal holding company rules. The bill would provide that stock of a foreign personal holding company that is owned by a partnership, estate or trust that is not a U.S. shareholder, or by a foreign corporation that is not a foreign personal holding company, would be considered (for income inclusion purposes) as being owned proportionately by its partners, beneficiaries, or shareholders. This rule would apply to trace ownership through tiers of such entities. The bill would grant regulatory authority to the Secretary of the Treasury to provide for such adjustments in the foreign personal holding company rules as may be necessary to carry out the purposes of this tracing rule. Such an adjustment could be necessary, for example, to prevent double taxation of foreign personal holding company income subject to tax once by virtue of ownership of shares in a foreign personal holding company by a foreign corporation (other than a foreign personal holding company) and again on a dividend distribution by the foreign corporate shareholder.

Effective Date

The provisions would apply to taxable years of foreign corporations beginning after December 31, 1983.

Revenue Effect

These provisions would have a negligible revenue effect.

4. Ordinary Income Treatment on Disposition of Stock of Certain Foreign Corporations (sec. 504 of the bill and sec. 1248 of the Code)

Present Law

When a U.S. person sells or exchanges stock of a controlled foreign corporation (generally a foreign corporation of which more than half of the combined voting power of all classes of stock entitled to vote is owned directly, indirectly, or constructively by U.S. persons who own 10 percent or more of that voting power), some of the gain may be taxed as ordinary income, not as a capital gain (sec. 1248(a)). The purpose of this rule is to deny capital gains treatment to income accumulated in foreign corporate solution that has not been taxed by the United States. The gain is ordinary (dividend) income rather than capital gain only to the extent of post-1962 earnings and profits (E&P) accumulated while the shareholder held the shares and that were not previously taxed by the United States.

The Internal Revenue Code also imposes tax at ordinary income rates in certain cases upon the liquidation of a U.S. corporation that owns stock of a controlled foreign corporation (sec. 1248(f)). This rule includes in the income of the liquidating U.S. corporation as a dividend the difference between the value of its stock in the controlled foreign corporation and its adjusted basis in that stock to the extent of untaxed post-1982 E&P accumulated while the liquidating corporation held the shares.

Double counting.—If a U.S. corporation owns stock in a controlled foreign corporation and that U.S. corporation liquidates, the liquidation of the U.S. corporate owner generates dividend income to it on account of the accumulated E&P of the controlled foreign corporation, but the Internal Revenue Code does not reduce the E&P of the controlled foreign corporation by the amount of that income inclusion (see Rev. Rul. 71-388). That is, the taint of the previously untaxed E&P remains even though the E&P has borne tax. A subsequent distribution by the controlled foreign corporation could cause dividend treatment on account of E&P that had already caused a dividend inclusion. In addition, the new owner may take the position that it is entitled to foreign tax credits for taxes imposed on the controlled foreign corporation that the first owner (the liquidated corporation) has already credited. This double credit, if current law allows it, could reduce U.S. tax on other foreign income twice.

Similarly, when a U.S. person sells an interest in a controlled foreign corporation and recognizes dividend income on account of accumulated E&P, the Internal Revenue Code does not reduce the E&P of the controlled foreign corporation in the hands of the new owner. If the new owner receives a distribution from the controlled foreign corporation, the new owner is subject to tax at ordinary income rates on account of the E&P accumulated while the first owner owned the stock. Taxpayers credit the same taxes twice in this case also.

Indirect ownership.—Some taxpayers take the position that they may avoid ordinary income treatment on E&P of a controlled foreign corporation by a series of transactions between related parties. The first step in this series is the contribution of the stock in the corporation (a first-tier foreign subsidiary of a U.S. parent) to the capital of a second controlled foreign corporation (also a first-tier subsidiary of the U.S. parent). The second step is the sale or exchange of the stock of the second controlled foreign corporation (which now owns the first controlled foreign corporation). Taxpayers contend that the E&P that the first foreign corporation accumulated before the contribution of its stock to the second corporation is not subject to ordinary income treatment. They take the position that a cross-reference in the Code (sec. 1248(c)(2)(D)(ii)) indicates that E&P accumulated during direct ownership does not count when a U.S. person disposes of an interest held indirectly (as a second-tier subsidiary).

Issues

The issues include—

(1) whether the recapture of deferred E&P of a foreign corporation and the later taxation of the E&P upon distribution is double taxation that should be prevented and if so, whether it should be prevented only in the liquidation case or more generally; and

(2) whether there should be a distinction for the purposes of section 1248 between direct and indirect ownership of foreign entities.

Explanation of Provisions

Double counting.—The bill provides that to the extent that accumulated E&P has previously characterized income as ordinary income, that same E&P would not again characterize income as ordinary income. Therefore, if a U.S. corporation owns stock in a controlled foreign corporation and that U.S. corporation liquidates, the dividend income generated on account of the accumulated E&P of the controlled foreign corporation would, in effect, reduce the E&P of the controlled foreign corporation by the amount of that income inclusion. Similarly, if a U.S. person sells its interest in a controlled foreign corporation and recognizes dividend income on account of accumulated E&P, that income inclusion would, in effect, reduce the E&P of the controlled foreign corporation in the hands of the new owner. The bill would clarify present law to provide that, in any case, the new owner would not be entitled to foreign tax credits for taxes imposed on the controlled foreign corporation that the first owner had already credited or could have credited.

Indirect ownership.—The bill clarifies current law to provide that E&P that a foreign corporation accumulated while controlled by U.S. owners is subject to ordinary income treatment whether its U.S. owners controlled it directly or indirectly.

Effective Date

These provisions would each apply to sales or exchanges of stock of controlled foreign corporations that occur after the date of enactment.

Revenue Effect

These provisions would have a negligible revenue effect.

5. Coordination of Subpart F with Foreign Personal Holding Company Provisions (sec. 505 of the bill and sec. 951 of the Code)

Present Law

Congress enacted the foreign personal holding company rules in 1937 to prevent U.S. taxpayers from accumulating investment income tax-free in foreign "incorporated pocketbooks." In 1962, Congress imposed tax on the U.S. shareholders of foreign corporations engaging in certain tax-haven type activities by adding the Subpart F rules to the Internal Revenue Code. The Subpart F rules, as amended, impose tax when a controlled foreign corporation has "Subpart F income," and in other circumstances.

Subpart F income includes income from related party sales and services transactions through tax haven-type base companies, from insurance of U.S. risks, from shipping operations (unless the income is reinvested), from foreign oil related activities, and from passive investments. Some of this income may also be taxable under the 1937 rules as amended. Subpart F imposes a tax (although not on "Subpart F income") in other circumstances, such as investment by a controlled foreign corporation of its earnings in U.S. property, and a controlled foreign corporation's withdrawal of its previously excluded income from shipping operations.

In cases where there is overlap between the foreign personal holding company rules and the Subpart F rules, the foreign personal holding company rules generally take priority. A taxpayer who is subject to tax under the foreign personal holding company rules may contend that it is not subject to the Subpart F rules that year. For instance, taxpayers (who are shareholders in a foreign corporation that is both a foreign personal holding company and a controlled foreign corporation) have taken the position that being subject to foreign personal holding company tax exempts them from taxation under Subpart F on investment in U.S. property of earnings of the foreign corporation. Courts have split on this issue. *Compare Whitlock* v. *Commissioner*, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (holding the taxpayer liable for tax under Subpart F), *with Lovett* v. *United States*, 621 F.2d 1130 (Ct. Cl. 1980) (holding that no Subpart F tax was due).

Issues

The issues include—

(1) whether the present rules coordinating the operation of the foreign personal holding company rules and Subpart F are adequate; and

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(2) whether there should be a rule providing for taxation under both regimes but reducing the tax to the extent that there is double counting.

Explanation of Provision

The bill would repeal the rule that taxation under the foreign personal holding company rules precludes taxation under the Subpart F rules. It would substitute a new mechanism for the avoidance of double taxation. The bill would provide that a controlled foreign corporation's Subpart F income is taxed under Subpart F—but not under the foreign personal holding company rules—to the extent that it would be taxable under both Subpart F and the foreign personal holding company rules. Therefore, the existence of income subject to tax under the foreign personal holding company rules would not preclude taxation of Subpart F income to the extent that Subpart F income were greater than foreign personal holding company rules. In addition, taxpayers taxable under Subpart F on amounts other than Subpart F income (on such items as withdrawals from foreign base company shipping income and investments in U.S. property) would be taxable under Subpart F whether or not their foreign corporation subjected them to foreign personal holding company tax. These latter amounts would be subject to tax only under Subpart F.

Effective Date

This provision would apply to taxable years of U.S. shareholders beginning after the date of enactment.

Revenue Effect

This provision would result in a revenue gain of less than $5 million during each fiscal year during the period 1984-1988.

6. Stapled Stock (sec. 506 of the bill and new sec. 269B of the Code)

Present Law

Taxpayers have devised schemes for tax avoidance wherein the stock of two (or more) entities is "stapled" or "paired" so that a shareholder cannot trade the stock separately. Typically, however, the management of the two entities is the same.

Foreign corporations whose shares are sufficiently dispersed among U.S. persons are not subject to certain U.S. tax rules. The anti-tax-haven rules of Subpart F of the Code and the anti-international boycott rules apply to foreign corporations only if more than 50 percent of the total combined voting power of their stock is owned (directly or indirectly) by U.S. shareholders owning at least 10 percent of the stock each. The foreign personal holding company rules apply only if more than 50 percent of a corporation's outstanding stock (in value) is owned (directly or indirectly) by five or fewer U.S. shareholders. Widely held U.S. corporations have attempted to avoid these rules by splitting off their foreign operations and conducting them through separate corporations.

The stock of the foreign corporation is "stapled to" or "paired with" the stock of the original U.S. company so that a shareholder cannot buy or sell the stock of one corporation without buying or selling the stock of the other. Assuming the U.S. corporation, and thus the new foreign corporation, are sufficiently widely held, this device arguably reaches the result that the new foreign corporation is not subject to the Subpart F and anti-boycott rules because the 10-percent shareholder test is not met. This device may similarly allow avoidance of the foreign personal holding company rules. It is not clear, however, that these split-offs have the tax consequences that these U.S. corporations seek. Although there is authority that would tend to support the integrity of these split-offs, see, e.g., Rev. Rul. 54–140, 1954–1 C.B. 116, other authority indicates that the courts will not respect the formation of such a "quasi-subsidiary." *De Coppet* v. *Helvering,* 105 F.2d 787 (2d Cir. 1940), *cert. denied,* 310 U.S. 646.

Stapling of stock of two or more U.S. corporations could allow shareholders to benefit from multiple surtax exemptions and from multiple accumulated earnings tax credits. In addition, companies may split off certain investments into a separate company that will qualify for special tax treatment as a Real Estate Investment Trust (REIT) or a Regulated Investment Company (RIC). This special treatment would not be available if the companies were consolidated.

In these examples, and potentially in other cases where tax benefits among related parties are limited or where tax penalties may be imposed on related parties, companies may use stapled stock to appear to be unrelated.

Issues

The issues include--

(1) whether foreign corporations that are stapled to U.S. corporations should be taxed as U.S. corporations;

(2) whether stapled domestic corporations should each be treated as owning the other for certain purposes;

(3) whether stapled entities should be treated as one for REIT and RIC purposes; and

(4) whether the Secretary of the Treasury should have the authority to prescribe regulations to prevent avoidance or evasion of U.S. tax through the use of stapled entities.

Explanation of Provision

The bill would provide generally that where a foreign and a domestic corporation are stapled entities, the foreign corporation would be treated as domestic. Stock in one corporation which constitutes a stapled interest with respect to stock of a second corporation would generally be treated as owned by the second corporation for purposes of Code section 1563; the effects of this section 1563 treatment include denial of multiple surtax exemptions and denial of multiple accumulated earnings tax credits. All stapled entities would generally be treated as one in determining whether any one is a REIT or RIC. These rules would be subject to modification by the Secretary of the Treasury by regulation. In addition, the Secretary of the Treasury would prescribe such regulations as would be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities. Such regulations would include, but would not be limited to, regulations providing the extent to which one stapled entity would be treated as owning the other stapled entity (to the extent of the stapled interest).

The bill would define the term "entity" to mean any corporation, partnership, trust, association, estate, or other form of carrying on a business or activity. The bill would define the term 'stapled entities' to mean any group of two or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consisted of stapled interests. Two or more interests would be stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of such interests the other such interests would be also transferred or would be required to be transferred.

Effective Date

In general, this provision would take effect on the date of enactment of the bill. However, for interests stapled on or before the date of introduction (June 30, 1983), the amendment would not apply until January 1, 1985.

Revenue Effect

This provision would result in a revenue gain of less than $5 million for each fiscal year during the period 1984-1988.

F. Miscellaneous Treasury Administrative Provisions (Title VI of the Bill)

1. Simplification of Certain Reporting Requirements (sec. 601 of the bill)

Present Law

The Department of the Treasury is required to report to the Congress regarding specific statutory provisions on an annual or other periodic basis. The provisions affected by the bill are discussed below.

DISC.—The Treasury Department is required by statute to submit an annual report on the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code.[16] This report is due 15-1/2 months after the end of each calendar year.

International boycotts.—The Treasury Department is required by statute to submit an annual report on the international boycott provisions of the Internal Revenue Code.[17] This report is to set forth the number of boycott reports filed for taxable years ending with or within that year, the number of such reports on which the taxpayer indicated boycott participation or cooperation, and a detailed description of the manner in which the boycott provisions of the Code have been administered during that calendar year. The Secretary is to transmit this report as soon after the close of each calendar year as the data become available.

Possessions corporations.—The Committee reports on the Tax Reform Act of 1976 require an annual report to the House Committee on Ways and Means and the Senate Committee on Finance on possessions corporations. The Committee reports stated that "The Treasury is to submit an annual report . . . setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects of the provision as well as the effects on investment and employment in the possessions."[18] The Committee reports indicated that these annual reports are to be submitted within 18 months following the close of each calendar year.

High income taxpayers.—The Tax Reform Act of 1976 requires the Department of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes.[19] The statute presently requires calculation of total income in the following three ways: (1) adjusted gross income (AGI) plus tax preference items (which are exclusions from gross income or deductions in arriving at AGI), (2) AGI less investment interest

[16] Sec. 506 of the Revenue Act of 1971, Public Law 92-178, imposes this requirement.
[17] Sec. 1067 of the Tax Reform Act of 1976, Public Law 94-455, imposes this requirement.
[18] H. Rep. No. 94-658, 94th Cong., 1st Sess. 259; S. Rep. No. 94-938, 94th Cong., 2d Sess. 282.
[19] Sec. 2123 of the Tax Reform Act of 1976, Public Law 94-455, imposes this requirement.

and expense (to the extent that they do not exceed investment income), and (3) AGI with both of these modifications. The statute also requires publication of the number of individuals with total incomes of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits they used to avoid tax.

Issues

The issues include—

(1) whether each of the foreign income reports should be required to be submitted by the Treasury Department less frequently; and

(2) whether the number of concepts required in the high income taxpayer publication should be reduced.

Explanation of Provision

The bill would modify several of the Treasury Department reporting requirements.

DISC.—The Secretary of the Treasury would be required to submit a report setting forth an analysis of the operation and effect of the DISC provisions for calendar 1981 and for each second calendar year thereafter. The DISC report would be due 27-1/2 months following the close of each such second year.

International boycotts.—The bill would require the Secretary to submit an international boycott report for every four-year period. The first four-year period would begin with calendar year 1983. The data required would be the data required under current law, for a four-year period rather than a one-year period. The report would be due as soon after the close of each four-year period as the data become available.

Possessions corporations.—The Secretary would be required to submit a report setting forth an analysis of the operation and effect of the possessions corporations provisions for calendar 1981 and for each second calendar year thereafter. The possessions corporations report would be due 18 months following the close of each such second year.

High income taxpayers.—The bill would require the Secretary of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes. Total income would be calculated and set forth by adding to adjusted gross income any tax preference items excluded from or deducted in arriving at AGI, and by subtracting any investment expenses incurred in the production of such income to the extent of the investment income. The bill would also require publication of the number of individuals with total incomes of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits that they used to avoid tax.

Effective Dates

The new rule for DISC reports and possessions reports would apply to reports for calendar years after 1980. The new rule for high income taxpayer reports would apply to information published after the date of enactment. The new rule for international boycott reports would apply to reports for periods after December 31, 1982.

Revenue Effect

This provision would have no revenue effect.

2. Removal of $1 Million Limitation on Working Capital Fund (sec. 602 of the bill and sec. 322(a) of Title 31)

Present Law

Under present law, the Treasury Department's Working Capital Fund provides for the financing of centralized, Department-wide services such as printing procurement, reproduction, telephone, and teletype functions (31 U.S.C. 322(a)). The fund is limited to a capitalization of $1 million. This limitation was set in 1970 when the Fund was established.

Issue

The issue is whether the capitalized-ceiling dollar limit on the Working Capital Fund of the Department of Treasury should be removed or increased.

Explanation of Provision

Under the bill, the $1 million limit on the Working Capital Fund of the Department of Treasury would be removed.

Effective Date

This provision would be effective upon enactment of the bill.

Revenue Effect

This provision would have no revenue effect.

3. Increase in Limitation on Revolving Fund for Redemption of Real Property (sec. 603 of the bill and sec. 7810 of the Code)

Present Law

Under present law, if real property on which the United States has or claims a lien is sold to satisfy a lien prior to that of the United States, the Internal Revenue Service may redeem the property generally within 120 days of the sale date (sec. 7425). This redemption right is exercised, however, only when the Service concludes that the sale price of such real property is significantly below the fair market value and if the sale price does not provide sufficient receipts to cover the government's lien.

All expenses necessary for the redemption by the Service of such real property are chargeable to a revolving fund. The fund is repaid upon a subsequent sale of the property. Under present law, the authorization for this fund may not exceed $1 million. This figure was established in 1966. Because of increases in the numbers of taxpayer delinquencies, escalating real property values, and a greater frequency in foreclosures, the present $1 million authorization for the revolving fund is insufficient to provide for all those cases where redemption of real property sold to satisfy a lien prior to that of the United States would be prudent.

Issue

The issue is whether the maximum authorization for the revolving real property redemption fund should be increased.

Explanation of Provision

The authorization limitation on the real property redemption revolving fund would be increased to $10 million.

Effective Date

The provision would be effective upon enactment of the bill.

Revenue Effect

This provision would not have a direct revenue effect. If pursuant to the increased authorization, additional funds are appropriated for the revolving fund and redemption rights are exercised more frequently, revenues could be increased.

4. Secretary of Treasury Authorized to Accept Gifts and Bequests (sec. 604 of the bill and sec. 322(a) of Title 31)

Present Law

At present, the Treasury Department has authority to accept voluntary services in connection with the sale of public debt obligations (31 U.S.C. 21). Also, the Department has joint authority with the General Services Administration to accept gifts for the purpose of reducing the national debt (31 U.S.C. 3113) and for defense purposes (50 U.S.C. 1151). However, the Secretary of the Treasury does not have general authority to accept gifts and bequests on a department-wide basis to carry out departmental functions. The Comptroller General has ruled that agencies may not accept gifts and bequests for assisting them in carrying out governmental functions in the absence of specific authorization (36 Comp. Gen. 268). At present, there are numerous statutes authorizing various agencies to accept gifts in connection with their operations, *e.g.*, the Department of Commerce (15 U.S.C. 1522), the Department of Transportation (49 U.S.C. 1657 (m)), and the Department of Housing and Urban Development (42 U.S.C. 3535(k)). In addition, department-wide gift authority is possessed by the Departments of Agriculture and State and numerous other agencies for the conduct of agency activities.

Issue

The issue is whether the Secretary of the Treasury should be authorized to accept gifts and bequests of property on behalf of the Treasury Department.

Explanation of Provision

The bill would authorize the Secretary of the Treasury to accept gifts and bequests of property for the purpose of aiding or facilitating the work of the Department of Treasury. Gifts and bequests of money and the proceeds from sales of other property so received would be deposited in a separate fund of the Treasury to be disbursed upon the Secretary's order.

Effective Date

The provision would be effective upon enactment.

Revenue Effect

The provision would have no revenue effect.

5. Repeal of Stamp Requirements for Distilled Spirits (sec. 605 of the bill and secs. 5205 and 5604 of the Code)

Present Law

Present law (sec. 5205) provides for the use of strip stamps on distilled spirits containers as a means of indicating that the Federal excise tax has been paid. The strip stamps, distributed free of charge to distillers and bottlers, are printed by the Bureau of Engraving and Printing at an estimated cost of $1.7 million annually according to a 1982 General Accounting Office report.[20] Although the regulations promulgated in 1980 under section 5205 have authorized the use of alternate methods, most distillers have continued to use the Government-supplied strip stamps as closure devices.

For many years, strip stamps were numbered and generally controlled by Federal employees (Bureau of Alcohol, Tobacco, and Firearms of the Treasury Department) physically located at the distillers' premises. The stamps were applied to the neck and cap of the distilled spirits containers after the Federal employees were satisfied that the spirits had been bottled in conformance with Federal laws and had determined the appropriate tax. However, the Distilled Spirits Tax Revision Act of 1979 (P.L. 96-39) significantly modified the Federal regulation and method of determining the taxation of distilled spirits. The new all-in-bond method of determining the tax on a proof-gallon basis eliminated the need for the physical presence of Federal employees at distilled spirits plants to control certain operations, including the determination of tax on distilled spirits before bottling. Consequently, strip stamps are now provided to distillers and placed on distilled spirits containers generally before the tax has been determined or paid. Thus, the strip stamp no longer signifies that the tax on the spirits has been paid or that the spirits have been lawfully bottled.

Issue

The issue is whether the strip stamp method of indicating payment of the Federal distilled spirits excise tax should be continued or repealed.

Explanation of Provision

The bill would repeal the strip stamp requirement for distilled spirits (sec. 5205), as well as the associated penalty provisions (sec. 5604).

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[20] U.S. General Accounting Office, "The Federal Government Can Save $1.7 Million Annually by Eliminating Strip Stamps" (GAO Report GGD-82-60; May 7, 1982).

Effective Date

The provision would be effective on January 1, 1984.

Revenue Effect

The provision would not have any effect on budget receipts, but would save the Federal Government an estimated $1.7 million per year in costs of printing the strip stamps.

6. Extension of Time for Court Review of Jeopardy Assessment Where Prompt Service Not Made on Secretary (sec. 606 of the bill and sec. 7429 of the Code)

Present Law

Generally, the Internal Revenue Service may not assess any income tax without sending a written notice of deficiency allowing the taxpayer 90 days in which to petition the Tax Court for review of the Service's determination.

No assessment may be made until after the 90-day period has expired or, if a petition is filed, until after a decision of the Tax Court is final.

These deficiency procedures need not be followed, however, when the I.R.S. reasonably believes that collection of an alleged deficiency would be jeopardized by delay. In such a case, the Service may immediately assess and collect the tax (secs. 6851 and 6861).

In jeopardy assessment cases, the taxpayer is entitled to an expedited review by the Secretary, through the district director, of whether the determination of jeopardy was reasonable under the circumstances and whether the amount assessed and demanded was appropriate under the circumstances (sec. 7429). After review by the district director, the taxpayer is also entitled to a review by the appropriate United States District Court. Under present law, the District Court must decide whether the determination of jeopardy was reasonable under the circumstances and whether amount of the assessment was appropriate under the circumstances. This decision must be made within 20 days after an action by a taxpayer for review of the Secretary's determination is commenced. This action is a suit against the United States and, therefore, requires that the United States be given notice. However, neither the applicable statute (sec. 7429) nor the Federal Rules of Civil Procedure require service of notice of the action to be served on the United States within the 20-day period.

Issue

The issue is whether to extend the 20-day period for a court to make a decision with respect to a jeopardy assessment where the Secretary is not promptly served.

Explanation of Provision

Under the bill, if the District Court determines that proper service was not made on the Secretary within 5 days of the date on which the action is commenced, the 20-day period for action by the

District Court would not begin to run until the day proper service was made on the Secretary.

Effective Date

This provision would apply to actions commenced after the date of enactment.

Revenue Effect

This provision would have no revenue effect.

G. Tax Court Provisions (Title VII of the Bill)

1. Representation of Taxpayer (sec. 701 of the bill and secs. 7452 and 7463 of the Code)

Present Law

Under present law, taxpayers using the "small tax case" procedure may appear pro se or be represented by any person admitted to practice before the Tax Court. In general, small tax cases are cases involving $5,000 or less for any one taxable year or period. Such proceedings are generally conducted in a more informal atmosphere, and the Court's opinion is final and may not be appealed.

Under present law, no qualified person may be denied admission to practice before the Tax Court by reason of failing to be a member of any profession. The Tax Court, therefore, permits persons other than lawyers to be admitted to practice before the Court after passing an examination. This examination tests the applicant's knowledge of substantive tax law, the Federal Rules of Evidence, and Rules of Practice and Procedure of the United States Tax Court. Those who take the examination and successfully complete it, primarily accountants, may then represent taxpayers before the Court in both small tax cases and regular cases. In recent years, less than one hundred persons per year have taken the examination, and less than 10 percent of those taking the examination successfully pass it.

Issues

The issues include—

(1) whether certified public accountants and enrolled agents should be permitted to represent taxpayers in small cases before the Tax Court, and

(2) whether the Tax Court should be allowed to discontinue its examination procedure for non-attorneys.

Explanation of Provision

The bill would permit taxpayers to be represented in the Tax Court in small tax cases by certified public accountants and enrolled agents who are authorized to practice before the I.R.S., regardless of whether such persons are admitted to practice before the Tax Court.

In addition, the Tax Court would not be required to admit non-attorneys to practice before the Tax Court in regular decision cases. Thus, the Tax Court's examination procedure could be terminated at the discretion of the Court.

Effective Date

The admission of non-attorneys to practice in small tax cases would be effective on the date of enactment. The provisions with respect to practice before the Tax Court in regular decisions would be effective with respect to admission on and after the date of enactment.

2. Survivor Annuities (sec. 702 of the bill and sec. 7448) of the Code)

Present Law

Under the survivors annuity plan for Tax Court judges, if a judge is survived by a spouse and a dependent child or children, an annuity equal to one-half the annuity of the surviving spouse (but not to exceed the lesser of $900 per year divided by the number of such children or $360 per year) is payable to each child. If a judge leaves no surviving spouse, but leaves a surviving dependent child or children, the annuity payable to each child is equal to the annuity to which a surviving spouse would have been entitled, but not to exceed $480 per year.

These maximum annuity amounts have not been changed since 1961, although the limits for annuities to surviving children of other Federal judges have been increased.

Issue

The issue is whether the maximum benefit for dependent surviving children of Tax Court judges should be increased.

Explanation of Provision

Under the bill, the maximum annuities receivable by surviving children of a deceased Tax Court judge in the case where the judge also leaves a surviving spouse would be increased from $900 per year per family ($360 per child) to $4,644 per year per family ($1,548 per child). The comparable amounts for surviving dependent children where the judge leaves no surviving spouse would also be increased to a maximum annuity not in excess of $5,580 per year per family, or $1,860 per child, whichever is less.

These maximum limits are equal to those currently in effect for other Federal judges.

Effective Date

These provisions would be effective for annuities payable for months after the date of enactment.

3. Assignment of Proceedings (sec. 703 of the bill and sec. 7456 of the Code)

Present Law

Present law (sec. 7456 (d)) provides that the Chief Judge of the Tax Court may assign to the Court's commissioners for hearing and decision any declaratory judgment proceeding, any small tax case proceeding, and any other proceeding where the amount in dispute does not exceed $5,000, subject to such review as the Court may provide.

Issue

The issue is whether additional proceedings may be assigned to commissioners, subject to review and final decision by a Tax Court judge.

Explanation of Provision

A technical change would be made to allow the Chief Judge of the Tax Court to assign any proceeding to a special trial judge for hearing and to write proposed opinions, subject to review and final decision by a Tax Court judge, regardless of the amount in issue. However, special trial judges would not be authorized to enter decisions in this latter category of cases.

Effective Date

The provision would be effective as if enacted as part of the Miscellaneous Revenue Act of 1982.

4. Special Trial Judges (sec. 704 of the bill and sec. 7456 of the Code)

Present Law

The Chief Judge of the Tax Court is authorized to appoint "commissioners" to hear small tax cases and declaratory judgment actions, who must proceed under rules promulgated by the Court.

Issue

The issue is whether the title of the Tax Court "commissioners" should be changed to "special trial judge."

Explanation of Provision

The title of "commissioner" would be changed to "special trial judge."

Effective Date

The provision would be effective on date of enactment of the bill.

5. Publicity of Tax Court Proceedings (sec. 705 of the bill and sec. 7461 of the Code)

Present Law

All reports of the Tax Court and all evidence received by the Court are open to public inspection, except that after its decision in a case which has become final, the Court may permit the withdrawal of documents from the record or make such other disposition thereof as it deems advisable.

Rule 103(a) of the Tax Court's Rules of Practice and Procedure provides that the Court may make any order which justice requires to protect a party or other person from annoyance, embarrassment, oppression, or undue burden or expense, including an order requiring that a deposition or other written materials be placed under seal, that a trade secret or other information not be disclosed or be disclosed only in a designated way, or that documents or information be filed in sealed envelopes to be opened only as directed by the Court.

Issue

The issue is whether the Tax Court should be given specific authority to allow it to prevent the disclosure of trade secrets and other confidential information.

Explanation of Provision

The bill would clarify that the Tax Court may take any action necessary to prevent the disclosure of trade secrets and other confidential information.

Effective Date

The provision would take effect on the date of enactment of the bill.

Revenue Effect

The provisions relating to the Tax Court would not have a revenue effect.

H. Simplification of Income Tax Credits (Title III of the bill and secs. 31-53 of the Code)

Present Law

Present law provides a series of nonrefundable income tax credits which are allowable to reduce a taxpayer's tax liability. The credits have been added to the Internal Revenue Code over the years on an ad hoc basis, and presently the various credits are allowable against tax in the chronological order they were added to the Code. This results in several effects which probably were not intended. For example, certain credits for which no carryover is provided may become unusable while a lower-numbered credit for which a carryover is provided is used up. If the order had been reversed, a different result would have occurred.

Differences exist in the manner the various business credits may be used to reduce tax liability. First, credit carryovers are usable in different chronological orders—the investment credits are used on an earliest year first (FIFO) basis, and the other credits are used on a current year first basis. Next, the tax liability limitations for the different business credits differ. The investment tax credit (other than the energy tax credit) may be used to reduce 100 percent of the first $25,000 of tax and 85 percent of the tax in excess of $25,000. The targeted jobs credit may be used against 90 percent of tax liability; the ESOP credit may reduce 100 percent of the first $25,000 of tax liability and 90 percent of the tax in excess of $25,000. The remaining business credits, including the energy tax credit, may reduce 100 percent of tax liability. In each case, tax liability means the income tax imposed reduced by lower numbered credits. Finally, the investment credit, targeted jobs credit, research activities credit, and ESOP credit have a 3-year carryback period whereas the alcohol fuels credit has no carryback period; these credits have a 15-year carryforward period.

Table 1 is a summary of information concerning the usability of the nonrefundable credits under present law.

Table 1.—Tax Credit Provisions and Order Under Present Law

Name of credit and order of application	Section No.	Tax liability limitation (percent)	User [1]	Carry-back years	Carry-forward years	Order of use [2]
Elderly and disabled	37	100	I	0	0	
Foreign tax	33	100	I and C	2	5	C
Investment	38	[3] 85	I and C	3	15	F
Investment—Energy	38	100	I and C	3	15	F
Contributions to candidates	41	100	I	0	0	
Child and dependent care	44A	100	I	0	0	
Targeted jobs	44B	90	I and C	3	15	C
Residential energy	44C	100	I	0	6	
Nonconventional fuel	44D	100	I and C	0	0	
Alcohol used as fuel	44E	100	I and C	0	15	
Research activities	44F	100	I and C	3	15	C
Employee stock ownership	44G	[3] 90	C	3	15	C
Clinical testing ("orphan drugs")	44H	100	I and C	0	0	

[1] I means individuals, estates and trusts. C means corporations.
[2] C means current year credits used first. F means credits used in chronological order (FIFO).
[3] 100 percent of the first $25,000 of tax liability.

Issues

The issues include:

(1) Whether the credits should be grouped into a more logical order than under present law;

(2) Whether the business credits should be subject to a uniform tax liability limitation and whether that limitation should be 100 percent of the first $25,000 of tax liability and 85 percent of the remaining tax liability; and

(3) Whether the carryover should be placed on a uniform 3-year carryback, 15-year carryforward, FIFO basis.

Explanation of Provision

Under the bill, the personal credits—the dependent care credit, credit for elderly and disabled, residential energy credit and political contribution credit—would be allowable against tax before all other credits. Next the foreign tax credit, credit for clinical testing of certain drugs, and fuel production credit would be allowable against tax under the conditions of present law.

The business credits—the investment tax credit (both the regular and the energy credits), targeted jobs credit, alcohol fuels credit, research activities credit, and ESOP credit—-would be combined into one general business credit. This credit would be allowable against 100 percent of the first $25,000 of tax liability and 85 percent of the remaining tax liability. Tax liability would generally mean the income tax imposed reduced by other nonrefundable credits. The credit would be used on a FIFO basis with a 3-year carryback and 15-year carryforward period.

Table 2 sets forth a summary of the credits as amended by the bill.

Table 2.—Tax Credit Provisions and Order Under H.R. 3475

Name of credit and order of application	Section No.	Tax liability limitation (percent)	User [1]	Carry-back years	Carry-forward years	Order of use [1]
Child and dependent care	21	100	I	0	0	
Elderly and disabled	22	100	I	0	0	
Residential energy	23	100	I	0	6	C
Contributions to candidates	24	100	I	0	0	
Foreign tax credit	28	100	I and C	2	5	C
Clinical testing ("orphan drugs")	29	100	I and C	0	0	
Nonconventional fuel	30	100	I and C	0	0	
Business credit [2]	38	[3] 85	I and C	3	15	F

[1] See footnotes under present law (table 1).

[2] Combined credit for investment credit, targeted jobs credit, alcohol used as fuel credit, research activities credit, and employee stock ownership credit.

[3] 100 percent of the first $25,000 of tax liability.

Effective Date

The provision would be effective for taxable years beginning after 1983.

Revenue Effect

The provision would increase revenues by $231 million in fiscal 1984, $460 million in fiscal 1985, $439 million in fiscal 1986, $402 million in fiscal 1982, and $203 million in fiscal 1988.

I. Repeal of Certain Obsolete Provisions (Deadwood) (Title IX of the Bill)

1. Termination of Rules Relating to Qualified Bond Purchase Plans and Retirement Bonds (sec. 901 of the bill and secs. 405 and 409 of the Code)

Present Law

Qualified bond purchase plans

Under present law, a plan maintained by an employer and funded through the purchase of bonds issued under the Second Liberty Bond Act is treated, for some purposes, as if it is a tax-qualified pension, profit-sharing, or stock bonus plan described in section 401(a) of the Code and exempt from Federal income taxation under section 50l(a), provided it meets some of the requirements of section 401(a).[21] In addition, the bonds must be issued in the names of the individual employees (including self-employed individuals) on whose behalf they are purchased and must be nontransferable. The terms of the bonds provide for payment of interest, or investment yield, only upon redemption and for cessation of interest accrual, or investment yield, not later than five years after the death of the individual in whose name it is purchased. Moreover, no amounts are included in an individual's gross income until the bonds are redeemed, which cannot occur until the named individual dies, becomes disabled, or attains age 59-1/2.

Redemptions of bonds purchased under qualified bond purchase plans are eligible for rollover to an individual retirement account or annuity (an IRA), provided the rollover is made within 60 days after the individual receives the proceeds of the redemption. If no rollover is made, the redemption is not eligible for the capital gains or 10-year income averaging treatment available for certain distributions from tax-qualified pension, profit-sharing, or stock bonus plans. The redemption is eligible, however, for certain estate tax exclusions provided to tax-qualified plans under section 2039.[22]

Individual retirement bonds

Present law provides that an individual annually may deduct up to the lesser of $2,000 or 100 percent of compensation (earned income in the case of a self-employed individual) for contributions to purchase a qualified retirement bond.[23] A qualified retirement bond is a bond issued under the Second Liberty Bond Act that accumulates interest until the time of redemption. The bonds are

[21] Sec. 405.
[22] Treas. Reg. sec. 20.2039-2(b).
[23] Sec. 409.

issued in the name of the individual (the registered owner) on whose behalf they are purchased and are not transferable.

When the bonds are redeemed, the full proceeds of the bonds, including interest earned, are included in the individual's gross income. Generally, a qualified retirement bond may not be redeemed until the registered owner dies, becomes disabled, or attains age 59-1/2. If a bond is redeemed before the registered owner attains age 59-1/2 (and has not died or become disabled), a 10 percent penalty tax is imposed on the redemption. A special rule applies to redemptions within 12 months of the date of purchase.

A qualified retirement bond ceases to bear interest in the year in which the registered owner attains age 70 -1/2 and the value of the bond is included in the registered owner's gross income in that year, whether or not the bond is redeemed. If the registered owner dies before age 70-1/2 or before the bond is redeemed, the bond ceases to bear interest five years after the registered owner's death or the date the registered owner would have attained age 70-1/2, if earlier.

Redemption proceeds from qualified retirement bonds are eligible for rollover to an individual retirement account or annuity. Additionally, redemption proceeds are eligible for certain estate tax exclusions.[24]

Termination of sales

In a news release dated April 27, 1982, the Treasury Department announced that sales of bonds for qualified bond purchase plans and individual retirement bonds would be terminated effective April 30, 1982. The Treasury Department indicated that sales of the bonds in recent months had been negligible. Bonds issued prior to April 30, 1982, continue to be governed by the terms and conditions in effect when they were issued.

Issue

The issue is whether sections 405 and 409 should be repealed as deadwood.

Explanation of Provision

The bill would repeal sections 405 and 409 of the Internal Revenue Code, relating to qualified bond purchase plans and individual retirement bonds. Notwithstanding the rules of section 405 (as in effect before repeal) and the terms of any bond issued under a qualified bond purchase plan, the bill would permit an individual to redeem a bond at any time even though the individual has not attained age 59-1/2.

Technical and conforming amendments would be made by the bill, including the redesignation of section 409A (relating to qualifications for tax credit employee stock ownership plans) as section 409.

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[24] Sec. 2039.

Effective Date

The provisions of present law generally would be terminated for obligations issued after December 31, 1983.

Revenue Effect

This provision would not have a revenue effect.

2. Repeal of Section 1251 (relating to gains from disposition of certain property used in farming) (sec. 902 of the bill and sec. 1251 of the Code)

Present Law

Section 1251 was enacted in 1969 to prevent certain high income taxpayers from using farm losses to defer their non-farm income and then later obtaining capital gains on the disposition of their farm property. The Tax Reform Act of 1976 terminated these provisions with respect to farm losses incurred after 1975.

Issue

The issue is whether section 1251 should be repealed as deadwood.

Explanation of Provision

The bill would repeal section 1251, as deadwood, since the section no longer serves a meaningful function.

Effective Date

The repeal of section 1251 would be effective for taxable years beginning after 1983.

Revenue Effect

This provision would have no revenue effect.

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