[JOINT COMMITTEE PRINT]

EXPLANATION OF TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984 AND OTHER RECENT TAX LEGISLATION

(TITLE XVIII OF H.R. 3838, 99TH CONGRESS; PUBLIC LAW 99-514)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation in consultation with the staffs of the House Committee on Ways and Means and Senate Committee on Finance, provides an explanation of the revenue provisions of the technical corrections title of the Tax Reform Act of 1986 (Title XVIII; H.R. 3838, 99th Congress, P.L. 99-514).[2]

The technical corrections title to the 1986 Act contains clerical, conforming, and clarifying amendments to provisions enacted by the Tax Reform Act of 1984, which was part of the Deficit Reduction Act of 1984 (P.L. 98-369), the Retirement Equity Act of 1984 (P.L. 98-397), and other recently enacted tax legislation. The amendments made by the title are meant to carry out the intent of Congress in enacting the original legislation. Therefore, no separate "Reasons for Change" is set forth for each provision.

The provisions of the technical corrections title are treated as enacted immediately before the other provisions of the 1986 Act (Title I-XVII). Many of the provisions which were amended by the technical corrections title were further modified by the other titles of the 1986 Act. Except as otherwise indicated, the amendments made by Title XVIII were effective as if included in the original legislation to which each amendment relates.

Part I of the document describes technical amendments to the Tax Reform Act of 1984 (1984 Act); Part II describes technical amendments to miscellaneous revenue provisions; and Part III describes technical amendments to the Retirement Equity Act of 1984 (REA). An Appendix provides the estimated revenue effect of the technical corrections title.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation* (JCS-11-87), May 13, 1987.

[2] For an explanation of the other provisions of the Tax Reform Act of 1986 (Titles I-XVII), see Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

TITLE XVIII OF THE TAX REFORM ACT OF 1986: TECHNICAL CORRECTIONS PROVISIONS [1]

I. TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984

A. Technical Corrections to Tax Freeze and Tax Reform Provisions

1. Tax Freeze Items

a. Finance lease rules (sec. 1801(a) of the Act and sec. 12(c) of the 1984 Act)

Prior Law

Under the finance lease rules, the fact that a lessee has a fixed-price purchase option or the leased property is limited use property is not taken into account in determining whether the agreement is a lease. The Tax Reform Act of 1984 [2] ("the 1984 Act") postponed the effective date of the finance lease rule, except for property acquired pursuant to a binding contract entered into before March 7, 1984, and certain other property.

Explanation of Provision

Under the 1984 Act, taxpayers can elect to have the amendment that defers the finance lease rules apply to any agreement entered into before March 7, 1984.

In addition, certain specified farm finance leases are not to be disqualified where a C corporation becomes a partner or beneficiary in the partnership or trust which was the lessor.

b. Telephone excise tax (sec. 1801(b) of the Act and sec. 4251 of the Code)

Prior Law

The 1984 Act extended the three-percent telephone excise tax through December 31, 1987. Due to a clerical error in enrolling the Act, the year 1985 was inadvertently deleted.

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[1] For legislative background of these provisions, see H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, title XV; H. Rep. 99-426, pp. 877-1068; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, title XVIII; S. Rep. 99-313, pp. 893-1114; and H. Rep. 99-841, Vol. II (September 18, 1986), pp. 841-860 (Conference Report).

[2] Division A of the Deficit Reduction Act of 1984 (P.L. 98-369).

Explanation of Provision

The Act restores the year 1985 to the table of years for which the three-percent telephone excise tax applies.

c. Electronic funds transfer for alcohol and tobacco excise taxes (sec. 1801(c) of the Act and secs. 5061 and 5703 of the Code)

Prior Law

The 1984 Act requires persons who were liable for $5 million or more in any alcohol or tobacco excise tax during the preceding calendar year to pay that tax by electronic funds transfer during the succeeding calendar year.

Explanation of Provision

The Act clarifies that all corporations that are members of a controlled group of corporations are treated as one person for purposes of the electronic funds transfer requirement. The term controlled group of corporations has the same meaning as under Code section 1563, except a 50-percent, rather than an 80-percent, common ownership test is applied. Congress understood that the Treasury Department administratively will apply this 50-percent common ownership requirement only with respect to taxes due after March 28, 1985.

Additionally, Treasury Department authority to apply these principles to a group of persons under common control where some members of the group are not corporations is clarified.

d. Distilled spirits held in foreign trade zones (sec. 1801(c)(3) of the Act and sec. 27(b) of the 1984 Act)

Prior Law

The 1984 Act increased the excise tax rate on distilled spirits from $10.50 to $12.50 per proof gallon, effective October 1, 1985. Previously removed spirits held for sale on that date were subject to a $2 "floor stocks" tax (subject to certain exceptions).

Because of the interaction of these provisions with the provisions regarding foreign trade zones (*see,* 19 U.S.C. sec. 81a *et seq.*), it was not clear whether distilled spirits held in a foreign trade zone on October 1, 1985, and subsequently entered into U.S. customs territory, would be subject to the floor stocks tax.

Explanation of Provision

The Act clarifies that distilled spirits held in a foreign trade zone on October 1, 1985, and entered into U.S. customs territory after that date, are subject to the floor stocks tax.

2. Tax-Exempt Entity Leasing

a. Treatment of use in unrelated trade or business (sec. 1802(a)(1) of the Act and sec. 168(j)(3)(D) of the Code)

Prior Law

In the case of 19-year real property, the 1984 Act defines "tax-exempt use property" as the portion of property that is leased to tax-exempt entities under disqualified leases. This definition applies only if the portion of the property leased in a disqualified lease is more than 35 percent of the property. That Act also provides that the term "tax-exempt use property" does not include any portion of a property that is used predominantly in a tax-exempt entity's unrelated trade or business.

Explanation of Provision

The Act clarifies that the portion of a property that is used in a tax-exempt entity's unrelated trade or business is not treated as used pursuant to a disqualified lease. For example, assume that a tax-exempt entity leases 100 percent of a building for a term of 21 years. Eighty percent of the building is used in the tax-exempt entity's unrelated trade or business, and 20 percent is used in its exempt function. No portion of the building constitutes tax-exempt use property because the portion used in a disqualified lease (20 percent) is less than 35 percent of the property.

b. Treatment of certain previously tax-exempt organizations (sec. 1802(a)(2) of the Act and secs. 168(j)(4)(E) and (9) of the Code)

Prior Law

Under the 1984 Act, the term "tax-exempt entity" includes any organization (other than certain farmers' cooperatives) that was exempt from U.S. income tax at any time during the five-year period ending on the date the property involved is leased to such organization (or any successor organization engaged in substantially similar activities).

Explanation of Provision

The Act clarifies that the rule for former tax-exempt organizations is not limited to property that is leased to such organizations; the rule applies with respect to any property other than property owned by a former tax-exempt entity or a successor organization. Under the Act, the five-year period ends on the date the property involved is "first used" by a former tax-exempt entity. Property is treated as first used by an organization (a) when the property is first placed in service under a lease to such organization, or (b) in the case of property owned by a partnership (or other pass-through entity) of which the organization is a member, the later of the day on which the property is first used by the partnership (or other pass-through entity) or the day on which the organization is first a member of such partnership (or other pass-through entity).

For purposes of the rules relating to property owned by a partnership, any "tax-exempt controlled entity" is treated as a tax-exempt entity. The term "tax-exempt controlled entity" is defined as any corporation that is not a tax-exempt entity if 50 percent or more (by value) of the corporation's stock is held directly or (by application of section 318) indirectly by one or more tax-exempt entities. In applying section 318, the rules relating to attribution from a corporation are to be applied without regard to the 50-percent test. Therefore, an entity will be treated as owning its proportionate share of stock held by a corporation in which the entity has a direct ownership interest, regardless of the entity's ownership percentage. For example, assume that each of three unrelated tax-exempt entities utilizes a wholly owned taxable subsidiary to invest in one-third of the stock of a fourth taxable corporation. The fourth taxable corporation acquires an interest in a partnership holding depreciable property. Under section 318(a)(2)(C), each tax-exempt entity would be treated as owning one-third of the stock in the fourth taxable corporation. Therefore, the fourth taxable corporation would constitute a tax-exempt controlled entity. Because the rules for attribution from a corporation are applied without the 50-percent threshold, the same result would obtain if the three unrelated tax-exempt entities invested in one-third of the stock of a single taxable corporation, and the taxable corporation organized a second taxable corporation; here, the second taxable corporation would constitute a tax-exempt controlled entity.

A tax-exempt controlled entity is not treated as a tax-exempt entity (or as a successor to a tax-exempt entity) if an election is made to treat any gain recognized by a tax-exempt entity on disposition of an interest in the tax-exempt controlled entity (as well as any dividends or interest received or accrued from the tax-exempt controlled entity) as unrelated business taxable income under section 511. The election binds all tax-exempt entities holding interests in the tax-exempt controlled entity.

The amendment relating to tax-exempt controlled entities applies to property placed in service after September 27, 1985, except property acquired pursuant to a written contract that was binding on that date and at all times thereafter. A tax-exempt controlled entity can elect to have the amendments apply to property placed in service on or before September 27, 1985.

The Act also clarifies that the Federal Home Loan Mortgage Corporation is not treated as a tax-exempt entity.

c. Repeal of overlapping regulatory authority (sec. 1802(a)(3) of the Act and sec. 168(j)(5)(C)(iv) of the Code)

Prior Law

The 1984 Act authorized the Treasury to determine whether any high-technology telephone station equipment or medical equipment is subject to rapid obsolescence. The Act also provides that the Treasury is to prescribe any other regulations that may be necessary or appropriate to carry out the purposes of section 168(j) (sec. 168(j)(10)).

Explanation of Provision

The Act repeals the overlapping regulatory authority relating to high-technology equipment.

d. Partnership rules (sec. 1802(a)(4) of the Act and secs. 168(j)(8)–(9) and 48(a)(5) of the Code)

Prior Law

The 1984 Act provides that sections 168(j)(8) (relating to property leased to a partnership) and 168(j)(9) (relating to property owned by a partnership) apply for purposes of paragraphs (4) and (5) of section 48(a) (relating to the nontaxable use restriction on investment credits).

Explanation of Provision

The Act clarifies the manner in which the partnership rules in section 168(j) apply for purposes of the investment credit provisions. Any portion of a property that is treated as tax-exempt use property by application of paragraph (8) or (9) of section 168(j) is excluded from the definition of section 38 property under paragraphs (4) and (5) of section 48.

e. Treatment of certain aircraft leased to foreign persons (sec. 1802(a)(5) of the Act and secs. 47(a) and 48(a) of the Code)

Prior Law

Section 47(a)(7) provides an exception to the investment credit recapture rules for certain leases of aircraft for use predominantly outside the United States. This exception applies if, inter alia, an aircraft that qualified for the credit in the taxable year in which it was placed in service would otherwise cease to qualify as section 38 property because it is used predominantly outside the United States.

Under the 1984 Act, generally, property that is leased for a term of less than six months qualifies as section 38 property, even if the lease is to a foreign person or entity. In the case of aircraft that is leased to a foreign person before January 1, 1990, and is used under a lease that qualifies for treatment under section 47(a)(7), investment credits are not recaptured if the term of such lease does not exceed three years.

Explanation of Provision

The Act clarifies that the short-term lease exception for aircraft is intended to permit the operation of section 47(a)(7), where property would otherwise cease to qualify as section 38 property because it is leased to a foreign person for use predominantly outside the United States, and not to provide an exception to the definition of section 38 property. The application of this provision is illustrated by the following example. Assume an aircraft is placed in service by a U.S. air carrier on January 1, 1986, and is used for the entire taxable year solely in the United States. On January 1, 1987, the aircraft is leased to a foreign person for use predominantly outside the United States, under a "qualifying lease" (within the meaning of section 47(a)(7)). The term of the lease is two years. Because of the application of new section 47(a)(9), as well as section 47(a)(7), no investment credit is recaptured. If such aircraft is disposed of or otherwise ceases to be section 38 property, investment credit recapture will be determined by disregarding the term of the lease to the foreign person. In the example above, at the end of the two-year lease term, although the U.S. air carrier has actually owned the aircraft for three years, the taxpayer is considered to have used the plane for only one year for purposes of the recapture rules.

f. Section 593 organizations (sec. 1802(a)(6) and (8) of the Act and sec. 46(e)(4) of the Code)

Prior Law

Under the 1984 Act, the lessor of property to a section 593 organization (or "thrift institution") is entitled to no greater a credit with respect to such property than the thrift institution would have been entitled to had it owned the property. That Act also provides rules designed to prevent taxpayers from circumventing the rules with respect to leased property by use of certain arrangements, other than service contracts but including partnerships, under which a thrift institution obtains the use of property.

Explanation of Provision

The Act clarifies prior law by expressly providing that a thrift institution cannot avoid the restriction on property leased to a section 593 organization by use of a partnership.

The Act also clarifies that the tax credit for rehabilitation expenditures is allowable on buildings leased to section 593 organizations in accordance with the rules applicable to buildings leased to tax-exempt entities.

g. Treatment of certain property held by partnerships (sec. 1802(a)(7) of the Act and sec. 168(j)(9) of the Code)

Prior Law

If a tax-exempt entity's share of partnership items would be treated as income or loss from an unrelated trade or business under section 511, then the partnership's property will not be treated as tax-exempt use property.

Explanation of Provision

The Act clarifies that the determination of whether a tax-exempt partner's share of partnership items is treated as derived from an unrelated trade or business is to be made without regard to the debt-financed income rules of section 514.

h. Treatment of service contracts (sec. 1802(a)(9)(C) of the Act and sec. 7701(e) of the Code)

Prior Law

Section 7701(e) provides rules for use in determining whether an arrangement structured as a service contract is more properly treated as a lease.

Explanation of Provision

Section 7701(e)(4) is amended by adding a cross reference to the definition of "related entity" in section 168(j).

i. Effective date provisions (sec. 1802(a)(10) of the Act)

(1) Section 31(g)(3)(B) of the 1984 Act is amended to clarify that transitional relief is provided only from the application of section 168(j)(9) (as added by the Act).

(2) Section 31(g)(4) of the 1984 Act is amended to clarify that certain credit unions qualify for transitional relief, that governmental action before May 23, 1984 qualifies a successor plan for the Greenville, South Carolina, Coliseum, and that certain actions taken with respect to the Essex County, New Jersey, Courthouse qualify as significant governmental action.

(3) Effective for property placed in service by the taxpayer after July 18, 1984, section 31(g)(15)(D) of the 1984 Act is amended to clarify that the transitional rule for certain aircraft applies to aircraft originally placed in service after May 23, 1983.

(4) Section 31(g)(17)(H) of the 1984 Act is amended to clarify that, in the case of Clemson University, the term "property" includes only the Continuing Education Center and component housing projects.

(5) Section 31(g)(17)(L) of the 1984 Act is amended to clarify that it applies to the Pennsylvania Railroad Station in Newark, New Jersey.

(6) Section 31(g)(20)(B)(ii) of the 1984 Act, which provides that improvements to property that qualify for transitional relief also qualify for relief unless the improvement is a substantial improvement, is amended to clarify that the substantial-improvement exception to the rule applies to personal property, as well as real property. This amendment will not apply to personal property if there was a binding written contract to acquire, construct, or rehabilitate the property (or if construction, reconstruction, or rehabilitation of the property began) on or before March 28, 1985.

3. Bonds and Other Debt Instruments

a. Treatment of amounts received on disposition of short-term obligations (sec. 1803(a)(1), (2) and (3) of the Act and sec. 1271 of the Code)

Prior Law

Section 1271 expressly provides that any gain realized on disposition of governmental short-term obligations is treated as ordinary income, to the extent of the ratable share of accrued acquisition discount. Long-standing judicial authority and Treasury regulations provide a basis for characterizing accrued original issue discount (OID) as ordinary income on disposition of nongovernmental obligations.

Explanation of Provision

The Act clarifies the treatment of amounts received on disposition of nongovernmental obligations. Under a general rule, any gain realized on disposition of a short-term nongovernmental obligation is treated as ordinary income to the extent of the ratable share of accrued OID. Taxpayers may elect to accrue OID with respect to a short-term nongovernmental obligation under an economic accrual formula, pursuant to which the daily portion of the discount is computed on the basis of the taxpayer's yield to maturity based on the issue price of the obligation, compounded daily. A similar election is provided for the computation of acquisition discount with respect to short-term governmental obligations. An election to account for discount under an economic accrual formula cannot be revoked without the consent of the Secretary.

b. Treatment of deduction of OID on short-term obligations (sec. 1803(a)(4) of the Act and sec. 163(e) of the Code)

Prior Law

In general, interest on a debt instrument with a maturity of one year or less which is payable at the maturity of the instrument is not deductible by a cash-method issuer until paid. See Treas. Reg. sec. 1.1232-3(b)(1)(iii) (providing that such interest is not included in the "stated redemption price at maturity" for purposes of section 1232, the predecessor of section 1273).

Explanation of Provision

The Act clarifies prior law by expressly providing in section 163(e) that a cash basis issuer of a short-term debt instrument may deduct original issue discount and any other interest only in the year of payment. A similar provision was included in the Conference Report to the Act. That provision was deleted in House Concurrent Resolution 328 (June 29, 1984) because it was deemed to be a mere restatement of preexisting law.

It is understood that some taxpayers have interpreted the deletion of this provision from the Concurrent Resolution as evidencing an intent to modify the prior-law proscription against deduction of interest on an accrual basis by cash-method issuers of short-term obligations. The purpose of this amendment is to clarify that no such result was intended.

c. Treatment of certain transfers of market discount bonds (sec. 1803(a)(5) of the Act and sec. 1276(d) of the Code)

Prior Law

Under the 1984 Act, an obligation issued in an exchange subject to section 351 (which provides nonrecognition treatment where appreciated property is transferred to an 80-percent owned corporation in exchange for stock or securities of the corporation) may fall within the definition of the term "market discount bond," without regard to whether the property transferred is a market discount bond (see the discussion of prior law, below). Thus, taxpayers are prevented from circumventing the rule that characterizes accrued market discount as interest by swapping a market discount bond for a new bond in a section 351 exchange. A different result may obtain, however, where a taxpayer swaps a market discount bond for stock in a section 351 exchange.

Explanation of Provision

The Act clarifies that taxpayers are prevented from circumventing the market discount provisions by transferring a bond with accrued market discount in a section 351 exchange. Under the Act, accrued market discount is taxed to the transferor of a market discount bond in a section 351 exchange, regardless of whether the transferor receives stock or securities in the exchange. The corporate transferee of the market discount bond will take the bond with a basis that reflects any gain recognized to the transferor (sec. 362(a)). If the stated redemption price of the bond exceeds the transferee's basis immediately after acquisition, then the bond will constitute a market discount bond in the hands of the transferee.

d. Treatment of bonds acquired at original issue for purposes of market discount rules (sec. 1803(a)(6) of the Act and sec. 1278(a) of the Code)

Prior Law

Because market discount is defined as any excess of stated redemption price over basis (excluding OID), it is arguable that market discount is created on issuance of obligations in certain nonrecognition (or nontaxable) exchanges. An example is provided by the application of the statutory definition to a bond issued in a section 351 exchange. Under section 358, the basis of a bond received in a section 351 exchange is determined by reference to the basis of the property transferred in exchange for the bond (in the hands of the transferor). Thus, the stated redemption price of the bond will exceed its basis to the extent of any appreciation in the transferred property. Assuming no OID, this excess could be viewed as market discount.

The 1984 Act provides that the rule that characterizes accrued market discount as interest on disposition of a bond is inapplicable to bonds issued on or before July 18, 1984. If a pre-enactment bond is exchanged for a newly issued bond in a tax-free transaction, however, the new bond is subject to the interest characterization rule, even if the holder of the bond essentially maintains the original investment.

Explanation of Provision

The Act clarifies that, except as provided by statute or by regulation, no market discount is created on the original issuance of a bond.

Under the Act, two statutory exceptions are provided. The first exception relates to bonds that are part of an issue that is publicly offered. Because the Act provides that the issue price of publicly offered bonds (other than bonds issued for property) is the price at which a substantial amount of the bonds are sold, the OID provisions are inapplicable to a portion of the OID with respect to bonds acquired on original issue by large investors at "wholesale" prices (at deeper discounts than those available to "retail" customers). Under the Act, market discount is created on original issuance of a bond if the holder has a cost basis determined under section 1012, and such basis is less than the issue price of the bond. The difference between the holder's issue price and basis is treated as market discount.

The second statutory exception applies to a bond that is issued in exchange for a market discount bond pursuant to a plan of reorganization. This exception is intended to prevent the holder of a market discount bond from eliminating the taint of unaccrued market discount by swapping the bond for a new bond (e.g., in a recapitalization). Solely for purposes of the interest characterization rule, however, this exception is inapplicable to a bond issued in exchange for a pre-enactment market discount bond where term and interest rate of the new bond is identical to that of the old bond.

If the adjusted basis of a bond is determined by reference to the adjusted basis of the bond in the hands of a person who acquired the bond at original issue, the bond will be treated as acquired by the taxpayer at its original issue.

e. Treatment of certain stripped bonds or stripped coupons (sec. 1803(a)(7) of the Act and sec. 1281(b) of the Code)

Prior Law

The 1984 Act requires the current inclusion in income of OID or acquisition discount with respect to short-term obligations held by certain taxpayers. This provision was intended to limit the scope of the rules that permit deferral to the ordinary investor.

Explanation of Provision

The Act requires the current inclusion in income of OID with respect to stripped bonds and stripped coupons held by the taxpayer who stripped the bond or coupon (or any other person whose basis is determined by reference to the basis in the hands of the stripper).

f. Accrual of interest on certain short-term obligations (sec. 1803(a)(8) of the Act and sec. 1281(a) of the Code)

Prior Law

Under section 1281 of the Code, certain taxpayers are required to include in income as interest for a taxable year that portion of the acquisition discount or OID on a short-term obligation that is allocable to the portion of the taxable year during which the taxpayer held the obligation. Acquisition discount is defined as the excess of the stated redemption price at maturity over the taxpayer's basis in the obligation. Similarly, OID is defined as the excess of the stated redemption price at maturity over the issue price of the obligation. The taxpayers affected are those for whom the cash method of accounting for interest income from short-term obligations is considered inappropriate.

Explanation of Provision

The Act clarifies that taxpayers subject to the rule for mandatory accrual are required to include in income for a taxable year all amounts of interest allocable to that year with respect to short-term obligations, irrespective of whether the interest is stated or is in the form of acquisition discount or OID, and irrespective of when any stated interest is paid. For example, a calendar-year taxpayer designated in section 1281(b) holds an obligation from the time it is issued on October 1, 1985 until its maturity on October 1, 1986. Under the Act, the taxpayer is required to include in income for 1985 the equivalent of three months interest on the obligation, regardless of whether the interest income is in the form of acquisition discount, OID, stated interest, or any combination thereof.

The provision will apply to obligations acquired after September 27, 1985.

g. Treatment of debt instruments issued for property where there is public trading (sec. 1803(a)(10) of the Act and sec. 1273(b) of the Code)

Prior Law

Under section 1273(b) of the Code, if a debt instrument is issued for property and either the debt instrument is traded on an established securities market or the property for which it is issued is stock or securities which are traded on an established securities market, the issue price of the instrument is the fair market value of the property.

Explanation of Provision

The Act permits the Secretary to designate in regulations other types of publicly traded property which for purposes of the issue price provisions will be treated like publicly traded stock or securities.

h. Amortization of bond premium (sec. 1803(a) (11) and (12) of the Act and sec. 171 of the Code)

Prior Law

If a taxable bond is purchased at a premium (i.e., at a price that exceeds the redemption price), the holder may elect to amortize the bond premium over the term of the bond (sec. 171). Amortizable bond premium is allowed as an ordinary deduction. In computing amortizable bond premium, taxpayers are permitted to use a straight-line method. For purposes of these rules, the term "bond" is defined to exclude bonds issued by individuals. An election to amortize bond premium is effective for all bonds held or acquired at or after the beginning of the first taxable year for which the election is made.

Explanation of Provision

The Act conforms the treatment of bond premium to the treatment of bond discount: bond premium is to be computed under a constant yield method. Amortizable bond premium is computed on the basis of the taxpayer's yield to maturity, determined by using the taxpayer's basis for the bond, and compounding at the close of each "accrual period" (as defined in section 1271(a)(5)). The Act also extends section 171 to obligations issued by individuals.

The provisions will apply to obligations issued after September 27, 1985. For taxpayers who have elections in effect as of the date of enactment, such elections will apply to obligations issued after that date only if the taxpayer so chooses (in such manner as may be prescribed by the Secretary).

The Act also provides that, in determining bond premium for bonds issued after May 6, 1986, the basis of the bond shall be treated as not exceeding its fair market value where the bond was received in an exchange in which the basis of the bond is determined by reference to the basis of the other property. This rule generally will not apply to an exchange of securities in a reorganization.

The Congress anticipated that the regulations relating to the treatment of bond premium by the issuing corporation (Treas. Reg. sec. 1.61-12(c)(2)) will be conformed to require the use of the constant yield method.

i. Bonds with partial principal payments (sec. 1803(a)(13) of the Act and sec. 1276(a)(3) of the Code)

Prior Law

The 1984 Act generally provided that gain on the disposition of a market discount bond is treated as interest to the extent of accrued market discount.

Explanation of Provision

The Act contains a provision relating to the treatment of market discount on debt instruments, the principal of which is paid in more than one installment. Under the Act, a holder of such a debt instrument takes accrued market discount into income upon receipt of amounts includible in the debt instrument's stated redemption price at maturity, to the extent of the amounts so received. Rules are provided to prevent double counting of any market discount. In addition, rules are provided to require the recognition of accrued market discount upon the stripping of a debt instrument.

The Act provides that the computation of the accrual of market discount on market discount bonds is to be provided by Treasury regulations. Until such time that the Treasury Department issues such regulations, the Congress intends in the case of debt instruments to which the provision applies, holders may elect to accrue market discount either on the basis of a constant interest rate or as follows: (1) for those debt instruments that have original issue discount ("OID"), market discount shall be deemed to accrue in proportion to the accrual of OID for any accrual period (i.e., the amount of market discount that accrues during a period is equal to the product of (a) the total remaining market discount, and (b) a fraction, the numerator of which is the OID for the period and the denominator of which is the total remaining OID at the beginning of the period), and (2) for those debt instruments that have no OID, the amount of market discount that is deemed to accrue shall be the amount of discount that bears the same ratio to the total amount of remaining market discount that the amount of stated interest paid in the accrual period bears to the total amount of stated interest remaining to be paid on the debt instrument as of the beginning of the accrual period.

In the case of debt instruments that would be subject to the OID rules contained in new Code sec. 1272(a)(6) (without regard to whether the debt instrument has original issue discount), the same prepayment assumption that would be made in computing OID would be made in computing the accrual of market discount (whether or not the taxpayer elects to accrue market discount on the basis of a constant interest rate). In addition, the Congress intends that the same rules that apply to the accrual of market discount on debt instruments whose principal is paid in more than one installment, also is applied in amortizing amortizable bond premium (within the meaning of sec. 171).

j. Clarification of transitional rule (sec. 1803(b)(1) of the Act and sec. 44 of the 1984 Act)

Prior Law

Section 44(b) of the 1984 Act (relating to effective dates), as amended by section 2 of Public Law 98-612, provides special test and imputation rates under sections 1274 and 483 for certain transactions occurring before July 1, 1985.

Explanation of Provision

The Act clarifies that the effective date for new section 1274 and section 483 as amended by the Act—transactions after December 31, 1984—is not accelerated by section 2 of Public Law 98-612.

k. Clarification of interest accrual with respect to transactions involving adequate stated interest (sec. 1803(b) (2) and (3) of the Act and sec. 44(b)(3) of the 1984 Act)

Prior Law

Section 44(b)(3)(A)(i)(I) of the 1984 Act provides that, after March 1, 1984, and before January 1, 1985 (the date on which new section 483 becomes effective), the unstated interest allocable to a taxable year must be computed on an economic accrual basis. Section 44(b)(3)(A)(i)(II) proscribes the accrual of interest on a noneconomic basis with respect to debt instruments issued in a sale or exchange after June 8, 1984, and before January 1, 1985, where there is adequate stated interest for purposes of section 483. That Act contains an exception for transactions pursuant to binding contracts in effect on March 1, 1984.

Explanation of Provision

The Act clarifies that, in the case of debt instruments issued for property in transactions occurring after December 31, 1984, whether involving adequate stated interest or inadequate stated interest, interest may not be computed using any method other than economic accrual, as described in Rev. Rul. 83-84, 1983-1 C.B. 9.

The Act also changes the binding contract date applicable to transactions involving adequate stated interest. The exception to the statutory requirement of economic accrual is made applicable to transactions occurring pursuant to a written contract that was binding on June 8, 1984 and at all times thereafter until the transaction was closed. No inference is intended regarding the proper treatment (under other provisions of the Code, or under general tax law principles) of noneconomic accruals of interest with respect to obligations issued before the effective date of the Act.

l. Clarification of effective date for repeal of capital asset requirement (sec. 1803(b)(5) of the Act and sec. 44(g) of the 1984 Act)

Prior Law

Section 44(g) of the 1984 Act provides that section 1272 (relating to the current inclusion of original issue discount) does not apply to any obligation issued before December 31, 1984, for obligations that are not capital assets in the hands of the holder.

Explanation of Provision

The Act clarifies that section 1272 does not apply to obligations issued on or before December 31, 1984, for obligations that are not capital assets in the hands of the holder.

4. Corporate Provisions

a. Debt-financed portfolio stock (sec. 1804(a) of the Act and sec. 246A of the Code)

Prior Law

The 1984 Act added a provision generally limiting the dividends received deduction for dividends received by a corporate shareholder with respect to debt-financed portfolio stock.

Explanation of Provision

The Act clarifies the rules for applying the provision in cases in which dividends are received from certain foreign corporations engaged in business in the United States. For example, assume that 70 percent of a domestic corporation's purchase price for portfolio stock of a foreign corporation described in section 245(a) is debt financed. Assume further that 60 percent of that foreign corporation's gross income is effectively connected with the conduct of a trade or business in the United States. In the absence of section 246A, the domestic corporation generally would be entitled to deduct 51 percent (85 percent times 60 percent) of any dividend received from the foreign corporation. Under section 246A and the Act, the domestic corporation generally is entitled to deduct only 15.3 percent ((30 percent times 85 percent) times 60 percent) of any such dividend.

b. Holding period rules for dividends received deduction (sec. 1804(b)(1) of the Act and sec. 246(c) of the Code)

Prior Law

Under prior law, as amended by the 1984 Act, a corporation must hold stock for more than 45 days (90 days in the case of certain preference dividends) in order to obtain a dividends received deduction with respect to any dividend on that stock. Days more than 45 days after the ex-dividend date and days on which the corporation's risk of loss is diminished are not taken into account. Under these rules, it can thus be determined on the 45th day after the ex-dividend date whether or not the holding period requirement will be met. However, prior law disallowed the deduction only if the stock had been disposed of by the corporation. Thus, prior law may have retroactively denied the dividends received deduction when the corporation disposed of the stock. This may have required filing amended returns in some cases and in other cases the period of limitations may have expired.

Explanation of Provision

The Act disallows the dividends received deduction where the holding period requirement is not met, without regard to whether the stock has been disposed of. Thus, where the holding period requirement has not been met on the 45th day (90th day in the case of certain preference dividends) after the ex-dividend date, the dividends received deduction will not be allowed. The amendment is not intended to require, for example, that the holding period be met by the date the dividend is received where the stock was acquired less than 45 days before that date, provided the stock is held for 45 days or more. No inference is intended as to the proper interpretation of prior law.

The provision applies to obligations acquired after March 1, 1986.

In addition, the Congress wished to clarify that the 1984 Act did not change the principle that the dividends received deduction is not disallowed by reason of an at-the-money or out-of-the money call option that affords the corporation no protection against loss, beyond the option price received, in the event the stock declines in value. See Revenue Ruling 80-238, 1980-2 C.B. 96.

c. Application of related party rule to section 265(2) of the Code (sec. 1804(b)(2) of the Act and sec. 53(e) of the 1984 Act)

Prior Law

Section 265(2) of the Code disallows the deduction of interest incurred or continued to purchase or carry tax-exempt obligations. This rule applies both to individual and corporate taxpayers.

The 1984 Act (Code sec. 7701(f)) provides that the Treasury Department is to prescribe such regulations as may be necessary or appropriate to prevent the avoidance of Federal tax provisions which deal with (i) the linking of borrowing to investment, or (ii) diminishing risks, through the use of related persons, pass-through entities, or other intermediaries. This provision was specifically intended to apply to (but not to be limited to) the disallowance rule provided by section 265(2).

Under the 1984 Act, the provision regarding related persons, pass-through entities, and other intermediaries was effective on the date of enactment (July 18, 1984).

Explanation of Provision

Under the Act, the provision regarding related parties, pass-through entities, and other intermediaries generally remains effective as of July 18, 1984 (i.e., the date of enactment). However, the Act clarifies that this provision, insofar as it relates to section 265(2) of the Code only, is effective for (1) term loans made after July 18, 1984, and (2) demand loans outstanding after July 18, 1984 (other than any loan outstanding on July 18, 1984, and repaid before September 18, 1984). "Demand loans" mean any loan which is payable in full at any time on the demand of the lender. For purposes of this effective date rule, any loan renegotiated, extended, or revised after July 18, 1984, is treated as a loan made after such date.

d. Exempt-interest dividends from regulated investment companies (sec. 1804(c) of the Act and sec. 852 of the Code)

Prior Law

Prior to the 1984 Act, a taxpayer could convert short-term capital gain into long-term capital gain by buying stock of a regulated investment company (or real estate investment trust) immediately before the ex-dividend date of a long-term capital gain distribution, receiving that distribution, waiting 32 days, and then selling the stock. That Act made conversion of this type more difficult. However, a problem similar to the long-term capital gain distribution problem that existed before that Act remains with respect to exempt-interest dividends received from a regulated investment company. Under prior law, a taxpayer could buy stock of a regulated investment company immediately before the ex-dividend date of an exempt-interest dividend, receive that dividend, wait 32 days, and then sell the stock. Any loss on the sale generally was recognized.

Explanation of Provision

Under the Act, if a taxpayer holds stock of a regulated investment company for 6 months or less, any loss on the sale or exchange of that stock is disallowed to the extent the taxpayer received exempt-interest dividends with respect to that stock. Conforming amendments are made, and an exception is provided for dispositions pursuant to a periodic liquidation plan.

In addition, the Secretary is given authority to shorten the 6 months requirement to a period of not less than the greater of 31 days or the period between regular dividend distributions where the RIC regularly distributes at least 90 percent of its net tax-

exempt interest. The distribution period is to be shortened only where the purpose of the holding period requirement can be adequately fulfilled without requiring that the stock be held 6 months. It is intended that a RIC which regularly distributes between 90 percent and 110 percent of its net tax-exempt income earned between dividend payment dates has satisfied the purposes of the holding period requirement.

The provision applies to stock with respect to which the taxpayer's holding period begins after March 28, 1985.

e. Accumulated earnings tax (sec. 1804(d) of the Act and sec. 562 of the Code)

Prior Law

Prior to the 1984 Act, individual taxpayers attempted to convert dividend income into capital gains through the use of non-RIC investment companies which received dividend income (which was eligible for a dividends received deduction) and did not distribute that income to their individual shareholders. In order to prevent this result, that Act clarified that these corporations were subject to the accumulated earnings tax. However, it may still have been possible to avoid dividend treatment through the use of stock redemptions, whereby the shareholder receives capital gains treatment and the investment company was relieved of the accumulated earnings tax (sec. 562(b)(1)).

Explanation of Provision

The Act provides that, except to the extent provided by the Secretary of the Treasury, no dividends paid deduction will be allowed, for purposes of the accumulated earnings tax, in the case of any stock redemption by a mere holding or investment company which is not a regulated investment company. The provision will apply to redemptions after September 27, 1985.

f. Definition of affiliated group (sec. 1804(e) (1) and (10) of the Act and sec. 1504 of the Code)

Prior Law

The 1984 Act substantially revised the definition of "affiliated group". To apply the new rules, a determination must be made as to the ownership of "stock" of a corporation. Under that Act and section 1504(a)(4), "stock" does not include stock which, among other things, has redemption and liquidation rights which do not exceed the paid-in capital or par value represented by such stock (except for a reasonable redemption premium in excess of such paid-in capital or par values).

Members of an affiliated group of corporations may file (or be required to file) consolidated returns. To be a member of an affiliated group for this purpose, a corporation has to be an "includible corporation". Under section 1504, certain corporations do not qualify as includible corporations. Thus, for example, a former DISC is not an includible corporation. Nor is a subsidiary of a former DISC. Under prior law, the accumulated DISC income of a former DISC was included in the gross income of its shareholders, as a dividend, over a period of up to 10 years. If the former DISC and its parent could file a consolidated return, the former DISC's accumulated DISC would go untaxed, i.e., the parent would eliminate the "dividend" under Treas. Regs. sec. 1.1502-14.

The 1984 Act substantially revised the rules relating to DISCs and former DISCs. Under the new rules, there is less reason to keep a former DISC and its parent from filing consolidated returns. Furthermore, if a former DISC is not treated as an includible corporation, its parent may be able to selectively deconsolidate subsidiaries. The provision applies to taxable years beginning after December 31, 1984.

Explanation of Provision

Section 1504(a)(4) is amended to exclude stock which has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium). The amendment makes irrelevant the accounting treatment given the issuance of the stock.

Under the Act, any DISC or any other corporation that has accumulated DISC income derived after 1984 will not be an includible corporation. It is intended that this provision will not affect the status of certain S corporations with DISC subsidiaries who were "grandfathered" by the Subchapter S Revision Act of 1982. It is intended that the December 31, 1984, effective date of the provision be applied at the DISC level, so that former DISC's which did not have any accumulated DISC income after 1984 can consolidate for its first taxable year beginning after 1984.

g. Effective date of affiliated group provision (sec. 1804(e) (2), (3), (4), and (5) of the Act and sec. 60 of the 1984 Act)

Prior Law

The 1984 Act substantially revised the definition of "affiliated group". The provision was generally effective for taxable years beginning after December 31, 1984. However, section 60(b)(2) of that Act provided a grandfather rule with respect to any corporation which on June 22, 1984, was a member of an affiliated group filing a consolidated return for such corporation's taxable year which includes June 22, 1984—for purposes of determining whether such corporation continues to be a member of such group for taxable years beginning before January 1, 1988, the provision does not apply. Under section 60(b)(3) of the 1984 Act, the grandfather rule described in the preceding sentence does not apply once a "sell-down" with respect to the corporation involved has occurred.

Explanation of Provision

The Act makes several technical changes with respect to the effective date rules.

First, the grandfather rule ceases to apply as of the first day after June 22, 1984, on which the corporation involved would not qualify as a member of the group under prior law. Thus, for example, a corporation which ceased to be a member of a group on July

31, 1985, under prior law but which on July 31, 1985 (and thereafter), qualifies as a member of the group under the Act's substantive rule is treated as continuing to be a member of the group.

Second, the Act amends section 60(b)(3) of the Act to clarify the "sell-down" exception to the grandfather rule. Thus, the exception does not apply, and the grandfather rule continues to apply, if the percentage interest (by fair market value) in the stock of the corporation involved held by other members of the group (determined without regard to section 60(b)(3) of the Act) does not decline as a result of the sale, exchange, or redemption of such corporation's stock. Also, the Act provides that the "sell down" exception applies in certain cases where there is a letter of intent between a corporation and securities underwriter entered into on or before June 22, 1984.

Third, the Act allows a common parent corporation to elect to have this provision apply to taxable years beginning after December 31, 1983.

Fourth, the Act provides that, during the applicable transition period, the affiliation requirements of the consolidated returns provisions will be applied to Alaska Native Corporations (and their wholly owned subsidiaries), and to another specified group of corporations, solely by reference to the express language in those provisions. Thus, eligibility for affiliation in the case of such corporations will be determined solely on the basis of ownership of stock satisfying the 80-percent voting power and 80-percent nonvoting stock tests, without regard (for example) to the value of the stock owned, to escrow arrangements, voting trusts, redemption or conversion rights, stock warrants or options, convertible debt, liens, or similar arrangements, or to the motive for acquisition of the stock or affiliation.

In addition, with certain specified exceptions, no provision of the Internal Revenue Code or principle of law will apply to deny the benefit of losses or credits of Native Corporations (or their wholly owned subsidiaries) to the affiliated group of which the corporation is a member or of the specified group of corporations, during the applicable transition period. Thus, in general, the benefit of such losses and credits may not be denied in whole or in part by application of section 269, section 482, the assignment of income doctrine, or any other provision of the Internal Revenue Code or principle of law.

Finally, the Act delays the effective date for one specified corporation until the earlier of January 1, 1994, or the date on which the voting power of certain preferred stock terminates, and exempts one specified corporation from the new rules.

h. Complete liquidations of subsidiaries, etc. (sec. 1804(b)(3), (e) (6), (7), (8), and (10) of the Act and secs. 332, 337 and 338 of the Code)

Prior Law

Prior to the 1984 Act, the rules applicable in determining whether a corporation qualified as a corporation which could be liquidated under section 332 were substantially similar to the general rules applicable in determining whether that corporation was a member of an affiliated group under section 1504. That Act substantially amended the general rules of section 1504 but not those of section 332. As a result, there is now discontinuity between the two sections. Thus, a corporation might be liquidated tax free under section 332 even though it and its "parent" are not members of the same affiliated group under new section 1504. The converse is also true. This discontinuity may produce unacceptable tax consequences.

For example, assume that beginning on January 1, 1985, P Corporation's ownership of S Corporation satisfies new section 1504 but not present-law section 332 and that, under new section 1504, P and S file consolidated returns for the 1985 calendar year. Assume further that (1) S adopts a plan of complete liquidation in 1985, then sells all its assets, and then liquidates within 12 months from the date the plan is adopted, and (2) P does not liquidate. Because S's liquidation does not qualify under section 332, S may be able to avail itself of section 337 (sec. 337(c)(2)). That result is appropriate so long as P is taxed on S's liquidation, as would in general be the result given the inapplicability of section 332. However, since P and S file a consolidated return, S's liquidation would not be taxable to P under Treas. Regs. sec. 1.1502-14(b) (assuming S distributes no cash to P in the liquidation). Therefore, S could dispose of all its assets and liquidate, with neither P nor S incurring any current tax liability.

As a further example, assume that (1) J Corporation's ownership of K Corporation stock satisfies present-law section 332 but not new section 1504, and (2) the two corporations are not filing a consolidated return under section 60(b)(2) of the Act for their 1985 calendar year. Assume further that K adopts a plan of complete liquidation, on January 1, 1985, then sells all its assets, and then liquidates within 12 months. Under section 332, the liquidation would not be taxable to J. Furthermore, it would appear that, since J and K are not in a new section 1504(a)(2) relationship, K may be able to avail itself of section 337 (sec. 337(c)(3)). Again, K could dispose of its assets and liquidate, with neither J nor K incurring any tax liability. (On the other hand, if J and K were filing consolidated returns under section 60(b)(2) of the Act, K could not avail itself of section 337 unless J timely liquidated. J would be a "distributee corporation" under section 337(c)(3)(B) since new section 1504 would not yet apply.)

Explanation of Provision

The Act amends section 332. Section 332 will not apply unless, among other things, the corporation receiving the liquidating distribution was, on the date of the adoption of the plan of liquidation and continued to be at all times until receipt of the liquidating distributions, the owner of stock in the liquidating corporation meeting the requirements of new section 1504(a)(2). In applying section 1504(a)(2) for this purpose, the objective is to harmonize section 332 and section 1504(a)(2). Thus, it is generally intended that other parts of new section 1504(a), e.g., section 1504(a)(4), are applicable. However, section (a)(5)(E) is not applicable. It is not concerned with section 1504(a)(2) but rather with the effect of transfers within a group of a member's stock.) The new rule also applies even if one (or both) of the corporations involved is not an includible corporation under section 1504(b). Under this rule, S in the first example above could be liquidated under section 332. However, S could avail itself of section 337 only if P complied with section 337(c)(3)(A)(i). In the second example above, J would be taxed because section 332 would not apply and because J and K, by definition, could not be filing a consolidated return.

Under the Act, the term "distributee corporation" under section 337(c)(3) is also amended. The amendment defines the term to mean any corporation which receives a distribution in a complete liquidation of the selling corporation to which section 332 applies. It also includes each other corporation "up the line" which receives a distribution in complete liquidation of another distributee corporation to which section 332 applies. Thus, assume, for example, that (1) M owns 100 percent of the stock of N, (2) N owns 100 percent of the stock of O, and (3) the 3 corporations are filing a consolidated return under new section 1504 for the calendar year 1985. If M transfers 30 percent of the stock of N to O, under regulations, the 3 corporations would continue to be eligible (or be required) to file a consolidated return (sec. 1504(a)(5)(E)). If N adopted a plan of complete liquidation, sold all its assets, and then liquidated within 12 months, under Treas. Regs. sec. 1.1502-34, both M and O generally would be entitled to tax-free treatment under section 332. Under the Act, N could not avail itself of section 337 unless, among other things, both M and O complied with section 337(c)(3)(A)(i).

Also, under the Act, the definition of "qualified stock purchase" in section 338 is conformed to the definition in section 1504(a)(2). The change will apply where the 12 month acquisition period begins after December 31, 1985.

The amendment to section 337(c)(3)(B) applies with respect to plans of complete liquidation pursuant to which any distribution is made in a taxable year beginning after December 31, 1984. Thus, in the example above involving J and K, K could not avail itself of section 337 unless J timely liquidated because J would be a "distributee corporation" under the amendment.

Except as indicated below, the amendment to section 332 is generally applicable with respect to distributions pursuant to plans of liquidation adopted after March 28, 1985. Except as indicated below, the amendment is also applicable with respect to distributions pursuant to a plan of complete liquidation adopted on or before that date, but only if (1) any distribution is made in a taxable year beginning after December 31, 1984, and (2) the liquidating corporation and any corporation which receives a distribution in complete liquidation of such corporation are members of an affiliated group of corporations which is filing a consolidated return for the taxable year which includes the distribution. However, the amendment to section 332 does not apply with respect to distributions pursuant to any plan of complete liquidation if the liquidating corporation is a member of an affiliated group of corporations under section 60(b)(2) or (5) (relating to Native Corporations established under the Alaska Native Claims Settlement Act) of the Act for each taxable year in which it makes a distribution.

The application of the effective date rules is illustrated by the following examples.

Example (1).—Assume that Q Corporation's ownership of the stock of R Corporation satisfies section 332 of Prior Law and section 1504 of prior law but not section 332 as it is amended by the Act. (Under these facts, Q and R could not be filing a consolidated return unless grandfathered under the Act's amendment of section 1504). Assume further that R adopts a plan of complete liquidation on October 1, 1984, then sells its assets, and, then, before October 1, 1985, completely liquidates. Regardless of whether Q and R are filing consolidated returns under section 60(b)(2) of the Act for the calendar year 1985, and regardless of whether the liquidation is completed before January 1, 1985, the amendment to section 332 would not apply. As a result, R's liquidation could qualify under section 332. (However, R could avail itself of section 337 only if Q timely liquidated.)

Example (2).—Assume that S Corporation's ownership of the stock of T Corporation would satisfy new section 332 but not section 332 of Prior Law or section 1504 of prior law. Assume further that on October 1, 1984, T adopts a plan of complete liquidation and then, making no sales or exchanges of assets in the interim, completes its liquidation on October 5, 1984. The amendment to section 332 would not apply. As a result, section 332 could not apply.

Example (3).—The facts are the same as in Example (2) except that (a) T adopts its plan on January 10, 1985, and completes its liquidation on January 15, 1985, and (b) S and T file a consolidated return for the calendar year 1985 under new section 1504. The amendment to section 332 would be applicable. As a result, section 332 could be applicable.

Example (4).—The facts are the same as in Example (2) except that T sells assets between October 1, 1984, and October 5, 1984. New section 332 would not be applicable. As a result, section 332 could not apply, and T could avail itself of section 337.

Example (5).—The facts are the same as in Example (3) except that T sells assets between January 10, 1985, and January 15, 1985. The amendment to section 332 would apply. As a result, section 332 could apply. If it did, T could not avail itself of section 337 unless, among other things, S timely liquidated. (If S and T were not filing a consolidated return under new section 1504 for the calendar year 1985, the amendment to section 332 would not apply. As a result, T's liquidation would not be a section 332 liquidation, and T could avail itself of section 337.)

Example (6).—Assume that Corporation U's ownership of the stock of Corporation V satisfies section 332 of Prior Law but not section 332 as it would be amended and that U and V are filing a consolidated return for the calendar year 1985, under section 60(b)(2) of the Act. On December 10, 1985, V adopts a plan of complete liquidation, then sells all its assets, and then liquidates on December 15, 1985. The amendment to section 332 would not apply. As a result, section 332 could apply. If it did, V could avail itself of section 337 only if, among other things, U timely liquidated.

Further, the Act delays the effective date of the amendment made to section 311(d) in the case of one specified parent-subsidiary group. The Act also provides that a specified corporation will be treated as having made a valid section 338 election with respect to a certain stock acquisition.

i. Earnings and profits (sec. 1804(f) of the Act and sec. 312 of the Code)

Prior Law

The 1984 Act substantially revised the definition of corporation's "earnings and profits".

One change was to increase a distributing corporation's earnings and profits by the amount of any gain which would be recognized if section 311(d)(2) did not apply to an ordinary, non-liquidating distribution by the corporation of appreciated property. However, the 1984 Act added no separate provision for reducing earnings and profits for all or any portion of that amount.

The 1984 Act also amended the rules regarding the effect on earnings and profits of a corporation's redemption of its own stock (sec. 312(n)(7) of current law). However, that Act did not contain a specific effective date for that amendment.

In addition, the 1984 Act provided that rules relating to installment sales would apply to foreign corporations only in the case of taxable years beginning after December 31, 1985.

Explanation of Provision

The Act repeals section 312(n)(4) and section 312(c)(3) and amends section 312(b). Under 312(b), as amended, the distribution by a corporation of property (other than an obligation of the corporation) [3] with respect to its stock, the fair market value of which exceeds its adjusted basis (for purposes of computing earnings and profits) increases the earnings and profits of the distributing corporation by the amount of such excess. The distribution results in a decrease to earnings and profits by the fair market value of the property under the general rules of section 312(a). Thus, assume that a corporation has no accumulated earnings and profits and no other current earnings and profits. Assume further that in 1985 it distributes property with a zero basis and a $1,000 value to an individual shareholder in a transaction described in section 311(d)(2). The distribution increases the distributing corporation's earnings and profits of the taxable year to $1,000. Thus, the distributing corporation's earnings and profits for the taxable year (as determined at the close of the taxable year under Treas. Reg. sec. 1.316-1(a)(1)) shall account for all gain attributable to the distribution of appreciated property. This change is not intended to affect the determination of earnings and profits with respect to a liquidation distribution for purposes of section 333.[4]

The Act provides that section 312(n)(7) of current law applies to redemption distributions in taxable years beginning after September 30, 1984.

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[3] A technical correction may be needed so that the statute reflects this intent. Such a correction was included in H.Con.Res. 395 as passed by the House and the Senate in the 99th Congress.

[4] See Revenue Ruling 87-1, I.R.B. 1987-1, January 12, 1987.

The effective date of the special rule for installment sales by foreign corporations is changed to taxable years beginning after December 31, 1987.

j. Treatment of transferor corporation (sec. 1804(g) and (h)(3) of the Act and secs. 361 and 368 of the Code)

Prior Law

In general, gain or loss is not recognized by a transferor corporation on the transfer of property pursuant to a plan of reorganization. However, gain is recognized where money or other property received is not distributed by the transferor pursuant to the plan of reorganization. The 1984 Act generally required that all property be distributed in a "C" reorganization. Nevertheless, if the transferor corporation uses money or other property to satisfy its liabilities, the transferor corporation may be treated as realizing gain on the transfer to the acquiring corporation.[5]

In addition, under prior law it is not entirely clear whether or not the nonrecognition provisions applicable to corporate liquidations apply to a corporate reorganization.[6]

Explanation of Provision

The Act amends section 361 to provide that the transferor corporation does not recognize gain or loss on the transfer to the acquiring corporation pursuant to the plan of reorganization, without regard to whether properties received are distributed pursuant to the plan of reorganization.[7]

In addition, the Act clarifies that sections 336 and 337 (relating to liquidations) are not applicable to transfers of property pursuant to the plan of reorganization.[8] In any type of reorganization, no gain or loss is recognized by the acquired corporation on a disposition of stock or securities (in a party to the reorganization) received from the acquiring corporation, provided the disposition is pursuant to the plan of reorganization.[9] Gain (but not loss) is recognized on distributions pursuant to the plan of any "boot" including preacquisition assets of the acquired corporation. However, under the provision, boot received from the acquiring corporation will generally take a basis equal to its fair market value at the time of transfer.[10]

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[5] See *Minnesota Tea Company* v. *Helvering*, 302 U.S. 609 (1938), Rev. Rul. 70-271, 1970-1 C.B. 166.

[6] See *FEC Liquidating Corporation* v. *United States*, 548 F.2d 924 (Ct. Cl. 1977) (the application of which would deny nonrecognition treatment under section 337 on a "deemed sale" of stock to a creditor); and, *General Housewares Corporation* v. *United States*, 615 F.2d 1056 (5th Cir. 1980) (holding that section 337 applied where the acquired corporation sold part of the stock received as considertion for its assets in a reorganization and used the sale proceeds to pay debts).

[7] This amendment was not intended to change the application of section 357(b) and (c). A further technical correction may be needed to clarify this intent.

[8] Although this provision was drafted with the prior law sections 336 and 337 in mind, it is intended to be equally applicable to sections 336 and 337 as amended by the Act. A further technical correction may be appropriate to clarify this intent.

[9] This provision is not intended, however, to affect the recognition of discharge of indebtedness income by the acquired corporation on a transfer to a creditor.

[10] A further technical correction may be necessary with respect to the treatment of certain obligations and rights to acquire stock of the acquiring corporation.

For purposes of this provision, a transfer to creditors of the acquired corporation will be deemed pursuant to the plan of reorganization if the acquired corporation distributes all its assets or is merged pursuant to the plan of reorganization (or, in the case of a "C" reorganization, the Secretary has waived the complete distribution requirement), and the transfer to creditors is pursuant to such distribution or merger. No inference is intended as to whether transfers of stock or securities to creditors in such circumstances may be regarded as pursuant to a plan or reorganization under prior law.

The Act also clarifies that the distribution requirement of section 368(a)(2)(G) will be satisfied where distributions are made to creditors, as well as shareholders, of the transferor corporation.

These provisions will apply to plans of reorganizations adopted after date of enactment of this Act.

The Act also clarifies that a reorganization, involving a "drop-down" of assets to a subsidiary, which qualifies as a "C" reorganization, without regard to section 368(a)(2)(A) (relating to reorganizations described in both paragraphs (C) and (D) of section 368(a)(1)), will continue to qualify as a reorganization.

k. Collapsible corporations (sec. 1804(i) of the Act and sec. 341 of the Code)

Prior Law

Under prior law, subject to certain exceptions, gain from the sale or exchange of a "collapsible" corporation which has been held for more than 6 months is treated as ordinary income.

Explanation of Provision

The Act applies the collapsible corporation provisions whether or not the stock has been held 6 months. The provision will apply to sales and exchanges after September 27, 1985.

l. Golden parachutes (sec. 1804(j) of the Act and sec. 280G of the Code)

Prior Law

Under prior and present law (sec. 280G), no deduction is allowed for "excess parachute payments" and a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment (sec. 4999).

Definition of parachute payment

Parachute payment.—A "parachute payment" is any payment (1) in the nature of compensation (including payments to be made under a covenant not to compete or similar arrangement); (2) to (or for the benefit of) a "disqualified individual"; and (3) which is contingent on a change in the ownership or effective control of a corporation, or on a change in the ownership of a substantial portion of the assets of a corporation, but only if the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds 3 times the disqualified individual's "base amount."

The disqualified individual's "base amount" is the average annual income in the nature of compensation with respect to the acquired corporation includible in the disqualified individual's gross income over the 5 taxable years of such individual preceding the individual's taxable year in which the change in ownership or control occurs.

A payment generally is not treated as a parachute payment to the extent the disqualified individual transfers cash or property in consideration for the payment. For example, if the original receipt or vesting of a stock option is treated as a payment in the nature of compensation, the exercise of the option is not treated as a parachute payment because the holder of the option transfers, in consideration for the stock, cash (the exercise price) and property (the option) having a total fair market value equal to the stock. Congress expects that, except as otherwise provided in regulations, the vesting of an option with an ascertainable fair market value (whether or not readily ascertainable as defined in Reg. section 1.83-7(b)) will be treated as the payment in the nature of compensation.

Similarly, if an employee receives the payment of his or her vested account balance in an individual account plan, whether or not qualified under the Code (sec. 401(a)), and actual interest or other earnings on plan assets are credited to each account as earned and prior to distribution, early payment normally would not increase the present value of this amount and this payment would not be a parachute payment. On the other hand, if a vested employee receives a pension benefit on change in control and the amount of the benefit is not actuarially reduced to reflect payment before the employee otherwise would have received payment absent the change of control, the employer is subsidizing the value of the early payment and the pension benefit would be a parachute payment. The amount of the benefit that is a parachute payment is the excess of the present value of the subsidized early payment over the present value of the benefit if it were payable at the date that the employee otherwise would retire under the plan.

Disqualified individual.—A "disqualified individual" means any individual who is an employee, independent contractor, or other person specified in regulations who performs personal services for the corporation and who is an officer, shareholder, or highly compensated individual of such corporation. Sec. 280G does not define the term "highly compensated individual." Personal service corporations and similar entities generally are treated as individuals for this purpose.

Change in ownership or control.—To be a parachute payment, a payment must be contingent on a change in ownership or control. Whether a particular transaction involves a change in the ownership or effective control of a corporation or in the ownership of a substantial portion of its assets is to be determined under all the facts and circumstances, giving due regard to the purposes of the provisions. Generally, the fact that individuals in effective control of a corporation increase their ownership interest does not necessarily constitute a change in the effective control or ownership of the corporation or a change in the ownership of a substantial portion of the assets of the corporation.

In general, a payment is to be treated as contingent on a change in ownership or control if such payment would not, in fact, have been made had no change in ownership or control occurred. A payment generally is to be treated as one which would not, in fact, have been made unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred.

A payment may also be contingent on a change in ownership or control if the change determines the time such payment is in fact to be made. Prior and present law does not require that a payment that is merely accelerated by a change in ownership or control to be treated as contingent on the change if the acceleration does not increase the present value of the payment. For example, the exercise of a currently vested and exercisable stock appreciation right (SAR) or a stock option, the original receipt or vesting of which was not treated as a payment in the nature of compensation, is not treated as a parachute payment merely because a change in control determines the time at which the SAR or stock option is exercised because the change in control does not affect, in any way, the present value of the SAR or stock option.

Excess parachute payments.—"Excess parachute payments" are any parachute payments in excess of the base amount that are not reasonable compensation for personal services actually rendered (or to be rendered) by the disqualified individual. Under prior law, the taxpayer had the burden of establishing, by clear and convincing evidence, that a parachute payment was reasonable compensation for personal services actually rendered (or to be rendered).

Reasonable compensation

Payments of compensation previously earned are generally to be treated as reasonable compensation under prior and present law, assuming they qualify as reasonable compensation under section 162. For example, if pension benefits are earned at a rate of 2 percent a year times years of service times final average compensation, benefits earned for service before a change in control are amounts previously earned. Therefore, these benefits are treated as reasonable compensation under this provision (after discounting for the probability that, absent the change, they would otherwise have been forfeited) if they so qualify under section 162 even if the benefits vest on a change in control. Of course, because these payments would not have otherwise been made without the change in control, they would be parachute payments. Solely for purposes of the parachute provisions, severance payments would not be treated as reasonable compensation because such payments are not made as payments for services rendered or to be rendered.

To the extent a taxpayer establishes that the payment involved is reasonable compensation for personal services, the payment involved is first applied against the base amount.

Violation of securities laws or regulations

Under prior law, the term parachute payment also included any payment under a contract that (1) provided for payments of a type which the Congress intended to discourage by enacting the new rules, and (2) violated any applicable Federal or State securities laws or regulations. However, the rules relating to reasonable compensation did not apply for purposes of determining how much of any such parachute payment was excessive and, therefore, the entire amount of such parachute payment in excess of the base amount was an excess parachute payment.

Under prior and present law, the treatment of a securities law violation as a parachute payment does not apply if the violation is merely technical in character or is not materially prejudicial to shareholders or potential shareholders.

Application

In determining whether payments contingent on a change in ownership or control equal or exceed 3 times the base amount, the value of amounts to be paid in the future is determined on a present value basis in accordance with the principles of section 1274(b)(2). Under that section, a discount rate equal to 120 percent of the applicable Federal rate, compounded semiannually, is used.

The provisions apply to that part of each parachute payment which is in excess of the portion of the base amount allocated to such payment. Under prior and present law, the portion of the base amount allocated to any payment is that portion of the base amount determined by multiplying the base amount by a fraction, the numerator of which is the present value of such payment, and the denominator of which is the aggregate present value of all such payments.

Effective dates

The provisions of the 1984 Act were effective for payments made under contracts entered into or renewed after June 14, 1984. The provisions were also effective for all payments made under a contract entered into before June 15, 1984, if, after June 14, 1984, the contract was amended or supplemented in significant relevant respect. A contract generally was to be treated as amended or supplemented if it was amended or supplemented to add or modify, to the disqualified individual's benefit, a change in ownership or control trigger, to increase amounts payable (or, if payment is to be made under a formula, to modify, to the disqualified individual's advantage, the formula) in the event of such a trigger, or to accelerate the payment of amounts otherwise payable at a later date in the event of such a trigger.

Explanation of Provisions

Exemption for certain corporations

In general.—Under the Act, the term parachute payment does not include any payment made to (or for the benefit of) a disqualified individual (1) with respect to a corporation that was, immediately before the change in control, a small business corporation or (2) with respect to a corporation no stock of which was, immediately before the change in control, readily tradable on an established securities market, or otherwise, provided shareholder approval was obtained with respect to the payment to a disqualified individual.

Small business corporation.—A corporation qualifies as a small business corporation if the corporation does not (1) have more than 35 shareholders, (2) have a shareholder who is not an individual (other than an estate or a qualifying trust), (3) have a nonresident alien as a shareholder, and (4) have more than one class of stock.

Corporation with no readily tradable securities.—The Secretary of the Treasury may, by regulations, provide that a corporation fails to meet the requirement that it have no stock that is readily tradable if a substantial portion of the assets of any entity consists (either directly or indirectly) of stock in the corporation and interests in the entity are readily tradable on an established securities market, or otherwise. For example, if a publicly traded corporation sells the stock of a 70 percent subsidiary and the assets of the subsidiary constitute a substantial portion of the assets of the parent, Congress intended that the exemption for a corporation with no readily tradable securities will not be available with respect to payments to disqualified individuals on account of the change in ownership or control of the subsidiary.

Congress was also concerned that, absent specific rules, a taxpayer might utilize the exemption for shareholder approval to avoid the golden parachute provisions by creating tiers of entities. Such avoidance is possible if the gross value of the entity-shareholder's interest in the corporation constitutes a substantial portion of such entity's assets. Congress contemplated that, in such cases, the Secretary will adopt regulations requiring approval of the owners of the entity rather than the approval of the entity itself. Of course, such shareholder approval may be obtained only if the entity shareholder also has no stock that is readily tradable. On the other hand, if the entity's interest in the corporation constitutes less than a substantial portion of its assets, approval of the compensation arrangement by the authorized officer of the entity is sufficient because the golden parachute provisions do not apply to the sale of less than a substantial portion of the assets of a corporation (in this case, the entity).

Several issues arise in the application of the shareholder approval requirements for a corporation the stock of which is not publicly traded. It is expected that regulations will address these issues, particularly the application of the shareholder approval requirements in the case of shareholders that are not individuals (i.e., the shareholders are partnerships, corporations, or other nonindividual entities), and to what extent nonvoting interests in the entity shareholder have the right to affect the approval of that shareholder. In general, it is anticipated that the normal voting rights of the entity shareholder will determine whether or not the shareholder approves the parachute payments. For example, limited partners with no right to vote on partnership issues generally would not be entitled to vote with respect to the partnership shareholder's approval of a parachute payment.

Treasury regulations are also expected to address the application of the shareholder approval requirements to entity shareholders that hold de minimis amounts of stock in the corporation.[11]

[11] A technical correction may be necessary so that the statute reflects this intent.

The shareholder approval requirements are met with respect to any payment if (1) the payment is approved by a separate vote of the shareholders who, immediately before the change in ownership or control, hold more than 75 percent of the voting power of all outstanding stock of the corporation and (2) adequate disclosure was made to all shareholders of the material facts concerning payments that, absent this exemption, would be parachute payments.

Congress intended that adequate disclosure to shareholders will include full and truthful disclosure of the material facts and such additional information as may be necessary to make the disclosure not materially misleading at the time the disclosure was made. Further, Congress intended that an omitted fact will be considered material if there is a substantial likelihood that a reasonable shareholder would consider it important.

A disqualified individual who is to receive payments that would be parachute payments (absent shareholder approval) and who is a shareholder is removed from the shareholder base against which the shareholder approval test is applied. A shareholder who is related (under the principles of sec. 318) to the disqualified individual described in the preceding sentence is also removed from the shareholder base. If all shareholders are disqualified individuals or related to disqualified individuals, then disqualified individuals are not removed from the shareholder base.

Reasonable compensation

In the case of any payment made on account of a change in ownership or control, the amount treated as a parachute payment will not include the portion of such payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered on or after the date of the change in ownership or control. Moreover, such payments are not taken into account in determining whether the threshold (i.e., 3 times the base amount) contained in the definition of parachute payments is exceeded.

Congress intended that reasonable compensation for services to be rendered may include, under certain circumstances, payments to an individual as damages for a breach of contract. For example, if an employer fires an employee before the end of a contract term, the amount the employee collects as damages for salary and other compensation may be treated as reasonable compensation for services to be rendered if (1) the damages do not exceed the compensation the individual would have received if the individual continued to perform services for the employer; (2) the individual demonstrates, by clear and convincing evidence, that the payments were received because an offer to work was made and rejected; and (3) any damages were reduced by mitigation. On the other hand, if damages are collected for a failure to make severance payments, damages collected would not be for personal services to be rendered because the individual does not have to demonstrate a willingness to work and reduce damages by mitigation.

Congress intended that evidence that amounts paid to a disqualified individual for services to be rendered that are not significantly greater than amounts of compensation (other than compensation contingent on a change in ownership or control or termination of employment) paid to the disqualified individual in prior years or customarily paid to similarly situated employees by the employer or by comparable employers will normally serve as clear and convincing evidence of reasonable compensation for such services.

The amount treated as an excess parachute payment is reduced by the portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered before the change in control. For purposes of this provision, reasonable compensation for services performed before the date of change is first offset against the base amount.

Exemption for payments under qualified plans

Under the Act, the term parachute payment does not include any payment from or under a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)), a qualified annuity plan (sec. 403(a)), or a simplified employee pension (sec. 408(k)). Moreover, such payments from or under a qualified plan are not taken into account in determining whether the threshold for excess parachute payments is exceeded.

Treatment of affiliated groups

The Act provides that, except as otherwise provided in regulations, all members of an affiliated group of corporations (sec. 1504) shall be treated as a single corporation for purposes of the golden parachute provisions. Any person who is an officer or highly compensated individual with respect to any member of the affiliated group is treated as an officer or highly compensated individual of such single corporation. Notwithstanding the general definition of an affiliated group of corporations, for purposes of this provision, an affiliated group of corporations also includes the following:

(1) Tax-exempt corporations;

(2) Insurance companies;

(3) Foreign corporations (unless the disqualified individual is employed by a foreign corporation that is acquired by another foreign corporation, neither of which is subject to tax in the U.S.);

(4) Corporations with respect to which a possession tax credit election (sec. 936) is in effect for the taxable year);

(5) Regulated investment companies and real estate investment trusts; and

(6) A DISC or former DISC.

The adoption of the affiliated group rules was not intended to create an inference with respect to the definition of a change in control.

Definition of highly compensated individual

Under the Act, the term highly compensated individual is defined to include only an employee (or a former employee) who is among the highest-paid one percent of individuals performing services for the corporation or for any corporation that is a member of an affiliated group or the 250 highest paid individuals who perform services for a corporation or for the affiliated group.

Excluded amounts

Under the Act, amounts that are not treated as parachute payments are not taken into account in determining whether the threshold contained in the definition of parachute payments is exceeded. This provision applies to (1) payments made with respect to a small business corporation or a corporation that satisfies the shareholder approval requirements; (2) payments that are reasonable compensation for personal services to be rendered on or after the date of the change of control; and (3) payments from or under a qualified plan.

Securities laws violation

The Act limits the treatment of payments made pursuant to an agreement that violates securities laws as parachute payments only to violations of generally enforced securities laws or regulations. Further, the Internal Revenue Service is to bear the burden of proof with respect to the occurrence of a securities law violation.

Effective date

The provisions are effective as if enacted in DEFRA. For example, amounts paid before the date of enactment under an agreement otherwise subject to the golden parachute provisions may be exempt from such provisions under the small business corporation exception, the shareholder approval exception, the exception for payments from or under a qualified plan, or exceptions for payments of reasonable compensation for services to be rendered. In addition, shareholder approval could be obtained after the date of enactment with respect to prior transactions.

Further, Congress intended that a contract is not treated as amended in a significant, relevant respect under certain circumstances. For example, if a nonqualified stock bonus plan is amended to prevent the forfeiture of previously granted but unvested shares in the event of the termination of the plan following a merger, consolidation, or sale, such an amendment is not treated as amending the plan in a significant, relevant respect. This rule applies provided that participants in the plan are entitled to no grandfathered parachute benefits that have the effect of compensating them for the possible forfeiture of shares in the event of a merger, consolidation, or sale of the corporation. Under the plan, if the company terminates the plan, the vesting of previously granted shares would continue as if the plan had not been terminated. If the company is sold, however, the plan could be terminated without allowing previously granted shares to continue to vest. Under this situation, participants are not entitled to benefits that are contingent on a change in ownership or control. Instead, the plan amendment merely prevents the possible forfeiture of benefits that could occur only in the event of the merger, consolidation, or sale of the corporation. On the other hand, whether an award made after June 14, 1984, under the plan constitutes a parachute payment will depend on the facts and circumstances at the time the award is made.

m. Corporate tax preferences (sec. 1804(k) of the Act and sec. 291 of the Code)

Prior Law

The 1984 Act generally increased the corporate tax preference cutback (sec. 291) from 15 to 20 percent.

Explanation of Provision

The Act makes several clerical amendments, including a clarification that the prior law DISC provision did not apply to subchapter S corporations.

5. Partnership Provisions

a. Retroactive allocations (sec. 1805(a) of the Act and sec. 706(d) of the Code)

Prior Law

The 1984 Act provides that specified cash basis items are allocated to the persons who were partners during the period to which the items were economically attributable. Items (or portions of items) which are attributable to periods before the beginning of the taxable year are assigned to the first day of the taxable year. The items are allocated to the persons who were partners during the period to which each item is attributable, in accordance with their varying interests in the partnership during that period. If the persons to whom all or part of such item is allocable are not partners in the partnership on the first day of the partnership taxable year in which the item is properly taken into account, their portion of such item must be capitalized by the partnership and allocated to the basis of partnership assets.

Explanation of Provision

The Act clarifies that the rule described in prior law applies to all cases in which the rule is necessary to allocate cash basis items to the period to which the items are attributable, even though no change in partnership interests occurs during the current taxable year.

b. Disguised sale transactions (sec. 1805(b) of the Act and sec. 707(a)(2)(B) of the Code)

Prior Law

The 1984 Act provides that, under Treasury regulations, if (1) a partner transfers money or other property (directly or indirectly) to a partnership, (2) there is a related direct or indirect transfer of money or other property by the partnership to that partner (or another partner), and (3) when viewed together, the transfers described above are properly characterized as a sale of property, the transaction is to be treated (as appropriate) as a transaction between the partnership and a non-partner or as a transaction between two or more partners acting in non-partnership capacities. This "disguised sale" rule is intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership, and thereby to defer or avoid tax on the transaction.

Explanation of Provision

The Act specifies that "disguised sale" treatment is to apply to cases in which the transfers to and from the partnership (as described above), when viewed together, are properly characterized as an exchange of property, as well as to cases in which such transfers are properly characterized as a sale.

c. Transfers of partnership interests by corporation (sec. 1805(c)(1) of the Act and sec. 386 of the Code)

Prior Law

The 1984 Act provided that for purposes of determining the amount (and character) of gain recognized by a corporation on any distribution or liquidating sale or exchange of a partnership interest, the distribution (or sale or exchange) is treated as a distribution (or sale or exchange) of the corporation's proportionate share of the recognition property of the partnership.

Explanation of Provision

The Act amends section 386 to specifically limit the amount of gain recognized by a corporation upon a distribution of a partnership interest in a nonliquidating distribution to which section 311 applies. The maximum amount of gain recognized by a corporation upon distribution to which section 311 applies of any partnership interest is the gain that would have been recognized upon the sale of the distributed interest at its fair market value. Thus, for example, a corporation that acquired its interest by making a cash contribution to an existing partnership would recognize no gain if it immediately distributed the interest to its shareholders, regardless of the basis of the partnership property attributable to its interest.

The amendment to section 386 does not affect the recognition of recapture income by a distributing corporation. Under section 751(a), a partner is required to treat the sale of a partnership interest as a sale or exchange of property other than a capital asset to the extent of the unrealized receivables (including recapture property) and inventory of the partnership attributable to the transferred interest. Thus, a corporation making a distribution of a partnership interest will recognize depreciation recapture with respect to the partnership recapture property attributable to the distributed interest.

The Secretary is given authority to promulgate regulations to prevent the use of this provision to avoid the nonrecognition of loss rule of section 311(a). In particular, the Congress was concerned that prior to a distribution of partnership interests a corporation might contribute to a partnership property the adjusted basis of which exceeds its fair market value, thereby reducing the gain inherent in the distributed partnership interests. Such "netting" of gain and loss property is not permitted by section 311 if loss property is distributed by a corporation. The Secretary should limit the

application of this provision where a distribution is preceded by the contribution of loss property to the partnership if the principal purpose of the contribution is to avoid the nonrecognition of loss rule.

d. Distributions treated as exchanges for purpose of partnership provisions (sec. 1805(c)(2) of the Act and sec. 761(e) of the Code)

Prior Law

The 1984 Act provides that any distribution not otherwise treated as an exchange is to be treated as an exchange for purposes of specified partnership provisions of the Code. The provisions to which this rule applies are section 708 of the Code (relating to continuation of a partnership); section 743 (relating to the optional adjustment to the basis of partnership property); and any other partnership provision (subchapter K of the Code) specified in Treasury regulations.

Explanation of Provision

The Act limits the application of the sale or exchange treatment rule to partnership interests which are distributed. The Act also allows the Secretary to provide exceptions to these rules. It is intended that exceptions might include a distribution of a partnership interest by an estate or testamentary trust by reason of the death of a partner will not be treated as a sale or exchange for purposes of section 708(b).

e. Like-kind exchanges (sec. 1805(d) of the Act and sec. 1031(a) of the Code)

Prior Law

Under the Code (section 1031), generally no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that is also to be held for productive use in a trade or business or for investment.

The 1984 Act provides that, for purposes of the like-kind exchange provision, property which was not identified as the property to be received by the taxpayer on the date the taxpayer relinquishes property, or before the day which is 45 days after that date, does not qualify as like-kind property.

Explanation of Provision

The Act specifies that like-kind property includes property identified as the property to be received by the taxpayer on or before (rather than only before) the date which is 45 days after the date on which the taxpayer relinquishes property.

6. Trust Provisions

a. Multiple trusts (sec. 1806(a) of the Act and sec. 643 of the Code)

Prior Law

The 1984 Act provides that under Treasury regulation, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts in the avoidance of Federal income tax.

This provision is effective for taxable years beginning after March 1, 1984.

Explanation of Provision

The 1984 Act provides that this provision is not applicable to any trust which was irrevocable on March 1, 1984, except to the extent corpus is transferred to the trust after that date.

b. Trust distributions (sec. 1806(b) of the Act and sec. 643 of the Code)

Prior Law

The 1984 Act provides that the basis of property received as a distribution from a trust or estate is to be the basis before the distribution adjusted for gain or loss recognized. An election was provided to recognize gain or loss on the distribution of property from a trust or estate.

Explanation of Provision

The Act clarifies that the election to recognize gain or loss applies to all distributions during a taxable year unless the election is revoked with the consent of the Secretary.

7. Accounting Provisions

a. Tax shelters (sec. 1807(a)(1) and (2) of the Act and sec. 461(i)(2) of the Code)

Prior Law

Generally, a cash basis tax shelter is not allowed a deduction with respect to an amount any earlier than the time at which economic performance occurs. An exception is provided under which prepaid expenses are deductible when paid if economic performance occurs within 90 days after the close of the taxable year. For purposes of this exception, in the case of oil and gas activities, economic performance is deemed to occur with respect to intangible drilling expenses when the well is "spudded." It is unclear whether the exception applies if economic performance occurs before the close of the taxable year, because this is not "within" 90 days after the close of the taxable year. For example, it is unclear whether the exception applies if a well is spudded in the last month of the taxable year.

In the case of the trade or business of farming, the farming syndicate rules of section 464 apply to any tax shelter described in section 6661(b) (i.e., the principal purpose of which is the avoidance or evasion of Federal income tax). For purposes of applying section 464 to these tax shelters, it is unclear whether the exceptions under section 464(c)(2) relating to holdings attributable to active management apply.

Explanation of Provision

The Act clarifies that the 90-day exception applies if economic performance occurs before the close of the 90th day after the close of the taxable year. Thus, for example, if a well is spudded in the last month of the taxable year, the requirement that economic performance occur before the close of the 90th day after the close of the taxable year is satisfied.

The Act also clarifies that any tax shelter described in section 6661(b) will generally be treated as a farming syndicate for purposes of section 464. However, any person meeting the requirements of section 464(c)(2) will not be subject to the provisions of section 464 with respect to that person's interest in a tax shelter.

b. Mine reclamation and similar costs (sec. 1807(a)(3) of the Act and sec. 468 of the Code)

Prior Law

The 1984 Act provided electing taxpayers with a uniform method for deducting, prior to economic performance, certain reclamation costs which are mandated by Federal, State, or local law. Deductions accrued under this method must be accounted for in a book reserve and are subject to recapture to the extent that reclamation costs are less than accumulated reserves.

Explanation of Provision

The Act clarifies that a reserve balance must be increased by the amount of deductions accrued in each year that are allocable to the reserve. The Act also clarifies that this provision is effective on July 18, 1984, with respect to taxable years ending after July 18, 1984.

c. Nuclear power plant decommissioning expenses (sec. 1807(a)(4) of the Act and sec. 468A of the Code)

Prior Law

The 1984 Act permitted electing taxpayers to accrue a deduction for contributions made to a qualified nuclear decommissioning fund (a "fund"), subject to certain limitations.

Explanation of Provision

The Act clarifies that a taxpayer shall be deemed to have made a payment to a fund at the end of a taxable year provided that payment is made within 2½ months after the close of that taxable year. Under a transitional rule, the Secretary of the Treasury is provided regulation authority to relax, and appropriately adjust, this 2½ month rule for payments allocable to a taxable year beginning before January 1, 1987, and to provide that no interest will be allowed with respect to periods before payment is made. The Act clarifies that the tax treatment of fund income provided in section 468A is in lieu of any other Federal income tax, that a fund's tax liability is not deductible from its gross income, and that for purposes of subtitle F ("Procedure and Administration") a fund shall be treated as a corporation and taxes imposed on the fund shall be treated similarly to corporate income taxes. The Act clarifies that a fund may invest only in those assets in which the Code permits a Black Lung Trust Fund to invest. The Act also clarifies that this provision is effective for taxable years ending after July 18, 1984.

d. Premature accruals (sec. 1807(a)(8) of the Act and sec. 461(h) of the Code)

Prior Law

Under prior law, an accrual basis taxpayer may not take a deduction for an item prior to the occurrence of economic performance. A liability of a taxpayer which requires a payment to another person and arises out a tort is not considered to be economically performed prior to the time payment to such other person is made.

Explanation of Provision

The Act provides that accrual basis taxpayers which have made a payment to an insurance company to indemnify themselves from tort claims arising from personal injury or death caused by the inhalation or ingestion of dust from asbestos-containing products will be treated as having satisfied the economic performance test if the payment is paid to an unrelated third party insurer prior to November 23, 1985, and such payment is not refundable. The provision is not to apply to any company which mined asbestos.

The Congress does not intend for any conclusion to be drawn from this provision as to what treatment should be accorded similar payments for similar policies in the future.

e. Treatment of deferred payments for services (sec. 1807(b) of the Act and sec. 467(g) of the Code)

Prior Law

Under section 467(g) of the Code, the Secretary of the Treasury is to prescribe regulations under which deferred payments for services will be subject to rules similar to those applicable to deferred rents.

Explanation of Provision

The Act clarifies that the regulations to be issued under section 467 relating to deferred payments for services will not apply to amounts to which section 404 or 404A applies, or to amounts subject to any other provision specified in regulations.

In addition, the Act permits a specified taxpayer whose primary business is providing architectural reserves to use the cash method of accounting.

f. Settlement funds (sec. 1807(a)(7) of the Act and sec. 461(h) of the Code)

Prior Law

The 1984 Act provides that liabilities are not treated as incurred prior to the time when economic performance occurs. In the case of the taxpayer's liability to another person, arising under any workers compensation act or any tort, economic performance occurs as payments to such person are made, except to the extent provided in regulations. It is unclear whether an irrevocable payment to a court ordered settlement fund, which extinguishes the tort liability of the taxpayer to a person (or class of persons), constitutes economic performance under that Act.

Explanation of Provision

General rule

The Act clarifies that under certain limited circumstances, an irrevocable payment to a court-ordered settlement fund that extinguishes tort liability of the payor (the "taxpayer") constitutes economic performance with respect to such liability. This provision applies only to qualified payments made to a designated settlement fund.

A designated settlement fund means a fund (1) which is established pursuant to a court order, (2) which extinguishes completely the taxpayer's tort liability with respect to a class of claimants,[12] as determined by the court, (3) which is managed and controlled by persons unrelated to the taxpayer, (4) in which the taxpayer does not have a beneficial interest in the income or corpus, and (5) to which no amount may be transferred other than qualified payments.

A qualified payment means cash or property, other than the stock or indebtedness of the taxpayer (or a related party), which is irrevocably contributed to a designated settlement fund pursuant to a court order.

A designated settlement fund is not qualified if the taxpayer may benefit from the corpus or income of the fund. Thus, if the taxpayer's future liability to claimants (or other parties) is contingent on the income of a settlement fund created by the taxpayer, then the taxpayer may benefit from the fund's income, and the fund is not qualified.

A designated settlement fund is taxed as a separate entity at the maximum trust rate. Gross income of a designated settlement fund includes income from investment of fund assets, but excludes qualified payments made to the fund. No deductions are permitted except for certain administrative and incidental expenses. Thus, distributions to claimants are not deductible.

[12] A technical correction may be necessary to clarify that a designated settlement fund must completely extinguish the taxpayer's tort liability with respect to a class of claimants.

A contribution of property to a designated settlement fund is treated as if the taxpayer sold the property for fair market value and donated the proceeds to the fund. Thus, the taxpayer's deduction is limited to fair market value. The taxpayer recognizes gain or loss at the time property is contributed, and the fund takes a fair market value basis in the property.

No deduction is allowed under this provision for payment to a fund of an amount received from the settlement of an insurance claim, if the amount received is excluded from the taxpayer's gross income.

The Act clarifies that payments to a trust or escrow fund, other than a designated settlement fund, do not constitute economic performance with respect to any tort liability of the taxpayer.

These provisions do not apply to liability arising from any workers compensation act or contested liabilities (within the meaning of section 461(f)); moreover, no inference about the prior law treatment of such liabilities is intended.

The Act provides that, except as provided in regulations, escrow accounts, settlement funds, or similar funds are subject to current taxation. If the contribution to such an account or fund is not deductible, then the account or fund is taxable as a grantor trust.[13] This provision is effective for accounts or funds established after August 16, 1986.

Transition rule

A corporation that filed a petition for reorganization under chapter 11 of title 11 of the United States Code on August 26, 1982, and which filed with the U.S. Bankruptcy Court a first amended and restated plan of reorganization prior to March 1, 1986, may elect to be taxed under a transition rule. Under the transition rule, a taxpayer may identify a separate account within a trust fund, created by the taxpayer as part of its plan of reorganization, as a designated settlement fund, provided such account meets certain requirements of a designated settlement fund. A designated settlement fund created under the transition rule is taxable at a rate of 15 percent (rather than at the maximum trust rates). In addition, the settlement fund's tax liability shall be assumed by the taxpayer without disqualification of the fund. Such tax liability is treated as a deductible expense of the taxpayer.

Under the transition rule, sale or distribution of the taxpayer's stock by a trust fund (other than by a separate account treated as a designated settlement fund, as described above) is, for purposes of section 1032, treated as a sale or distribution by the taxpayer.

8. Tax Straddle Provisions

a. Treatment of Subchapter S corporations (sec. 1808(a) of the Act)

Prior Law

The 1984 Act extended the mark-to-market and sixty percent long-term, forty percent short-term capital gain and loss treatment

[13] This provision reverses the holding in Rev. Rul. 71-119, 1971-1 CB 163.

applicable to commodities dealers to dealers in exchange-traded options, provided elections to adopt this treatment for positions carried forward from earlier taxable years into the taxable year including the date of enactment and to pay any increase in tax liability resulting from this election over 5 years, and permitted qualified incorporated commodities dealers and options dealers to elect S corporation status without regard to the requirement of prior law that the election be made by the 15th day of the third month of the taxable year for which it is effective.

Explanation of Provision

The Act makes clarifying amendments to ensure that S corporation taxable year limitations do not affect the elections relating to adoption of mark-to-market treatment for positions carried forward from earlier years, and to properly coordinate those elections with the S corporation election with respect to taxable years commencing before January 1, 1984 in the manner provided by regulations.[14]

b. Treatment of amounts received for loaning securities (sec. 1808(b) of the Act and sec. 263(g) of the Code)

Prior Law

The prior law requirement that interest and other carrying costs incurred to carry personal property constituting part of a straddle must be capitalized, as amended by the 1984 Act, limits the requirement to the excess of these costs over interest, discount income and dividend income with respect to the property that is subject to tax during the taxable year. A lender of securities to be used in a short sale may receive compensation from the borrower to replace interest, dividends, and other compensating amounts with respect to the loaned property and may also incur interest and other carrying costs with respect to the property that are subject to the capitalization requirement.

Explanation of Provision

The Act provides for the inclusion of compensating payments to a lender of securities used in a short sale in those taxable amounts that reduce interest and other costs required to be capitalized under section 263(g) of the Code.

c. Clarification of the exception for straddles consisting of stock (sec. 1808(c) of the Act and sec. 1092(d) of the Code)

Prior Law

The 1984 Act extended the straddle rules to straddles involving exchange-traded stock options. Exceptions were provided for a straddle consisting of stocks, or stock and a qualified cover call.

[14] See Treas. Reg. sec. 18.1362-1, 49 Fed. Reg. 38920 (October 1, 1984).

Explanation of Provision

The Act clarifies that the exception for stock does not operate to except straddles involving exchange traded stock options (other than qualified covered calls that offset stock).

d. Treatment of losses from pre-1981 straddles (sec. 1808(d) of the Act and sec. 108 of the 1984 Act)

Prior Law

Unlike taxpayers who conducted isolated straddle transactions prior to the effective date of ERTA solely for tax purposes, taxpayers in the trade or business of trading commodities conducted numerous straddle transactions in the normal course of their business. Section 108 was intended to clarify the treatment of losses claimed with respect to straddle positions entered into and disposed of prior to 1982 by taxpayers in the trade or business of trading commodities. It provided a profit-motive presumption in section 108(b) for such taxpayers because of the inherent difficulty in distinguishing tax-motivated straddle transactions from profit-motivated straddle transactions when the taxpayer was in the trade or business of trading in commodities.

Explanation of Provision

The Act makes clear that subsection (b) treatment is limited to those taxpayers in the business of trading commodities. The determination of whether a taxpayer is in the business of trading commodities is based upon all the relevant facts and circumstances. Under the statute as clarified by the technical correction, generally a taxpayer engaged in the business of investment banking who regularly trades in commodities as part of that business would be considered in the trade or business of trading commodities. If a person qualifies as a commodities dealer, the subsection (b) treatment applies with respect to any position disposed of by such person. It would, for example, apply without regard to whether the position was in a commodity regularly traded by that person, whether it was traded on an exchange on which the dealer was a member, or whether an identical position was re-established on the same trading day or subsequently. If an individual owns a seat on a commodities exchange, such individual will be treated as a "commodities dealer." Further, if a trading firm also regularly trades commodities in connection with its business, then the commodities trading will be deemed to be part of its trade or business. The latter rule applies only to the securities trading firm itself; it does not apply to separate individual trading of its partners, principals, or employees, nor to partnerships or other organizations formed for the principal purpose of marketing tax straddles.

The Act also clarifies that subsection (b) treatment is available not only with respect to a loss incurred directly by a commodities dealer, but also to a loss allocable to a commodities dealer in determining such person's income with respect to an interest in a partnership, S corporation, or trust. For example, in determining the tax liability of a commodities dealer who was a shareholder in an S corporation, a loss incurred by the corporation in the trading of commodities would be treated as a loss incurred by the commodities dealer. Of course, whether an individual is a commodities dealer is no way indicated merely because such individual has an interest in a partnership, S corporation or trust engaged in the trading of commodities.

In the case of trades on a domestic exchange described in Code section 1402(i)(2)(B), the identification of positions disposed of shall be as provided in exchange procedures, and records of the exchange or clearinghouse shall be controlling in the absence of proof that rules were violated. A taxpayer who does not satisfy the indicia of trade or business status, such as the taxpayer in *Miller v. Commissioner* (84 T.C. No. 55 (1985)), would not be considered in the trade or business of trading commodities. Further, the presumption would not be available in any cases where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member. The subsection (b) treatment is only for purposes of subsection (a), and no inference should be drawn that a loss is incurred in a trade or business for any other purpose, such as for purposes of section 162, 163(d) or 172.

Section 108 also restated the general rule that losses from the disposition of a position in a straddle are only allowable if such position was part of a transaction entered into for profit. A majority of the United States Tax Court in *Miller* interpreted section 108 as providing a new, less stringent profit standard for losses incurred with respect to pre-1981 commodity straddles. It was not the intent of Congress in enacting section 108 to change the profit-motive standard of section 165(c)(2) or to enact a new profit motive standard for commodity straddle activities. This technical correction is necessary to end any additional uncertainty created by the *Miller* case.

Further, the Congress intends that the Internal Revenue Service bring all outstanding pre-ERTA straddle litigation to a speedy resolution, so that the large docket of cases on this issue may be cleared, in a manner consistent with this legislation.

9. Depreciation Provisions

a. Straight-line election for low-income housing (sec. 1809(a)(1) of the Act and sec. 168 of the Code)

Prior Law

Section 111 of the 1984 Act extended the recovery period of real property (other than low-income housing) from 15 years to 18 years.[15] Taxpayers may elect to recover the cost of 18-year real property using a straight-line method over the regular 18-year recovery period.

Explanation of Provision

The Act clarifies that taxpayers may elect to recover the cost of low-income housing using a straight-line method over 15 years (but not 18 years).

[15] For purposes of this description, 18-year real property also includes 19-year real property.

b. Mid-month convention for real property (sec. 1809(a)(2) of the Act and secs. 57, 168, and 312 of the Code)

Prior Law

The 1984 Act provided a mid-month convention for the depreciation of 18-year real property (which does not include low-income housing). Under that convention, property placed in service (or disposed of) by a taxpayer at any time during a month is treated as having been placed in service (or disposed of) by the taxpayer in the middle of that month.

Explanation of Provision

The Act clarifies that the mid-month convention is to be applied whenever a depreciation computation with respect to 18-year real property is required under section 168, section 57(a)(12) (relating to accelerated cost recovery deductions as items of tax preference), or section 312(k) (relating to the effect of depreciation on earnings and profits). Thus, for example, if a taxpayer elects under section 168(b)(3) to depreciate 18-year real property on a straight-line basis over 18, 35, or 45 years, the mid-month convention applies in computing the deductions. Similarly, the mid-month convention applies in determining what cost recovery deductions "would have been allowable" under section 57(a)(12). Numerous conforming changes are also made. These amendments will not apply to property placed in service before June 23, 1984.

c. Bond-financed 18-year real property (sec. 1809(a)(4) of the Act and sec. 168(f)(12) of the Code)

Prior Law

Prior to the 1984 Act, section 168(f)(12) placed restrictions on cost recovery allowances with respect to 15-year real property financed by the proceeds of an industrial development bond. Those rules did not apply if the property was placed in service in connection with a project for residential rental property financed by the proceeds of obligations described in section 103(b)(4)(A). The 1984 Act generally provided that the cost of real property qualifying as recovery property could not be recovered over a period of less than 18 years.

Explanation of Provision

The Act clarifies that, in general, the cost of 18-year real property (which does not include low-income housing) financed by the proceeds of an industrial development bond cannot be recovered more rapidly than on a straight-line basis over 18 years, using a mid-month convention. This rule does not apply if the property is either (i) low-income housing (sec. 168(c)(2)(F)), or (ii) property which is placed in service in connection with a project for residential rental property financed with the proceeds of obligations described in section 103(b)(4)(A) but which is not low-income housing under section 168(e)(2)(F). Costs of the former can be recovered on an accelerated basis under ACRS over 15 years, using a first-of-the month convention, and costs of the latter can be recovered on an accelerated basis under ACRS over 18 years, using a mid-month convention.

The Act also clarifies that the provision of the 1984 Act relating to property financed with tax-exempt bonds does not apply to certain property excepted from the bond rules added in 1982.

d. Treatment of certain transferees of recovery property (sec. 1809(b) of the Act and sec. 168(f)(10) of the Code)

Prior Law

A transferee of recovery property generally may elect a recovery period or method for the property different from the period or method elected by the transferor. However, restrictions are imposed by section 168(f)(10) to prevent the use of certain kinds of asset transfers as a means to change the recovery period or method for the property involved. For transfers subject to those restrictions, the transferee must "step into the shoes" of the transferor with respect to so much of the transferee's basis in the property as is not in excess of the property's adjusted basis in the hands of the transferor. Under this rule, the transferee's cost recovery deductions with respect to that basis are the same as those that would have been allowed the transferor had no transfer occurred. The transferee can elect to depreciate any excess basis pursuant to any recovery period or method available under the general rules.

Asset transfers subject to the rule of the preceding paragraph include sale-leasebacks (sec. 168(f)(10)(B)(iii)), transfers between related persons (sec. 168(f)(10)(B)(ii)), and tax-free asset (carryover basis) transfers described in section 332, 351, 361, 371(a), 374(a), 721, or 731 (sec. 168(f)(10)(B)(i)).

Explanation of Provision

In cases described in sections 168(f)(10)(B)(ii) and (iii) of prior law, the "step into the shoes" rule is often too generous to the transferee. The rule has the general effect of permitting such a transferee higher cost recovery deductions than would have been allowed to a transferee in a case not covered by either section. Furthermore, the Act, in amending the rules regarding the depreciation of real property (other than low-income housing) qualifying as recovery property, did not clearly provide how section 168(f)(10) would apply.

The Act amends section 168(f)(10) with respect to recovery property placed in service by the transferor. In a case described in section 168(f)(10)(B)(ii) or (iii) (but not (i)) of prior law, the transferee does not "step into the shoes" of the transferor. Instead, the transferee starts depreciating the property as would any other new owner of it. However, to the extent of the adjusted basis of the property in the hands of the transferor, the transferee is treated as having made any election made by the transferor with respect to the property under section 168(b)(3) or section 168(f)(2)(C). Thus, for example, if the transferor had elected to depreciate 5-year property on a straight-line basis over 5 years, a transferee under section 168(f)(10)(B)(ii) or (iii) would be treated as having made the same election to the extent basis did not increase. Furthermore, the transferee would begin depreciating that basis in the year of the transfer over a new 5-year period. For purposes of this rule, if the transferor was depreciating 15-year real property on a straight-line basis, the transferee would be treated as having elected 18-year straight line depreciation. If the transferee's basis exceeded the transferor's adjusted basis, the transferee can depreciate the excess under the general rules.

The Act is not intended to affect the treatment of transactions between members of an affiliated group of corporations filing a consolidated return. In addition, the Act is not intended to affect a mere change in form of ownership not involving a sale or exchange. For example, the change from ownership as tenants-in-common to condominium ownership not involving percentage ownership change would not require the owners to begin depreciating the property over a new period.

With one exception, the Act does not amend section 168(f)(10)(B)(i). Thus, for example, in a section 351 transaction, the transferee steps into the transferor's shoes to the extent basis does not increase. However, the Act amends section 168(f)(10)(B)(i) to provide that it does not apply in the case of the termination of a partnership under section 708(b)(1)(B) (relating to the sale or exchange of 50 percent or more of the total interest in a partnership's capital and profits within a 12-month period).

The amendments apply to property placed in service by the transferee after December 31, 1985.

e. Installment sales of partnership interests (sec. 1809(c) of the Act and sec. 453(i) of the Code)

Prior Law

The 1984 Act denied installment sale reporting to the sale of depreciable property to the extent of depreciation recapture under section 1245 and 1250 of the Code.

Explanation of Provision

The Act clarifies that the depreciation recapture installment sale rule (sec. 453(i)) applies to the installment sales of partnership interests.

f. Films, videotapes, and sound recordings (sec. 1809(d) of the Act and sec. 167 of the Code)

Prior Law

Under the 1984 Act, films and videotapes cannot qualify as recovery property (sec. 168(e)(5)). Similarly, sound recordings do not qualify as recovery property unless an election is made under section 48(r)(1) (relating to treating a sound recording as 3-year property). Thus, their costs cannot be recovered under ACRS. If a film or videotape, or a sound recording, not qualifying as recovery property qualifies as tangible property, however, its costs may be recoverable under depreciation methods prescribed by section 167(b) (e.g., a declining balance method).

Explanation of Provision

Under the Act, films, videotapes, and sound recordings are not eligible for the accelerated depreciation methods available under section 167(b)(2), (3), or (4). However, the income forecast method or similar methods of depreciation are available.

The provision applies to films, videotapes, and sound recordings placed in service by the taxpayer after March 28, 1985. However, no inference is intended as to whether or not films, videotapes, or sound recordings, placed in service by a taxpayer on or before that date qualify for these accelerated depreciation methods.

g. Investment tax credit (sec. 1809(e) of the Act and sec. 48 of the Code)

Prior Law

The 1984 Act amended the 3-month rule of section 48(b) (relating to whether property qualifies as new section 38 property). Under that Act, rules relating to the qualification of certain property reconstructed by the taxpayer as new section 38 property were inadvertently deleted.

Explanation of Provision

The Act reinstates the provision that section 38 property the reconstruction of which is completed by the taxpayer qualifies as new section 38 property. The Act also provides that the 3-month rule is not applicable to section 38 property the reconstruction of which is completed by the taxpayer. Thus, property reconstructed by a taxpayer and then sold and leased back by the taxpayer within 3 months of the date actually placed in service is to be treated as placed in service on the date actually placed in service.

The Act also clarifies the applicability of the 3-month rule in the case of certain sale-leasebacks. Thus, assume that taxpayer A places eligible property in service by leasing it to taxpayer B. Assume further that, within 3 months of the date A placed the property in service, A sells the property to taxpayer C and taxpayer C leases the property back to A, subject to the lease to B. Assuming C's lease to A qualifies as a lease under applicable Code principles, the property will constitute new section 38 property in C's hands. The amendment clarifies that this result would occur under the prior statutory language.

Under the Act, the 3-month rule does not apply if the lessee and lessor so elect.

10. Foreign Provisions

a. Maintaining the source of U.S. source income (sec. 1810(a) of the Act and sec. 904(g) of the Code)

Prior Law

Prior to the 1984 Act, a U.S. taxpayer could convert U.S. source income to foreign source income by routing the income through a foreign corporation: Interest and dividend payments from (and income inclusions with respect to) an intermediate foreign corporation generally were foreign source income to the U.S. taxpayer. As foreign source income, the income could be free of U.S. tax under the foreign tax credit.

The 1984 Act added to the foreign tax credit rules new rules that prevent U.S. taxpayers from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. These rules do not apply if less than 10 percent of the foreign corporation's earnings and profits is from U.S. sources.

Prior to enactment of the 1986 Act, interest and dividends paid by a domestic corporation that earned less than 20 percent of its gross income from U.S. sources over a three-year period (an "80/20 company") were foreign source (Code secs. 861(a)(1)(B) and 861(a)(2)(A)). Therefore, a U.S. taxpayer could convert U.S. source income to foreign source income by routing it through an 80/20 company, as long as the company's U.S. source gross income remained below the 20-percent threshold.

The 1984 Act defines an "applicable CFC" as any controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on that date consisted of issuing CFC obligations or holding short-term obligations and lending the proceeds to affiliates. The 1984 Act provided that, if certain requirements are met, interest paid to an applicable CFC on a U.S. affiliate obligation issued before June 22, 1984 (the date of conference action) will be treated for all Code purposes as paid to a resident of the country in which the applicable CFC is incorporated.

The 1984 Act provides a transitional rule for certain interest received by "applicable CFCs." This rule exempts from the resourcing provisions interest paid by a U.S. affiliate on certain obligations issued before the effective date of the amendment by an applicable CFC, typically a U.S.-owned finance subsidiary located in the Netherlands Antilles.

A U.S. affiliate obligation is any obligation of a U.S. person related (within the meaning of Code section 482) to an applicable CFC holding the obligation. Interest paid on an obligation of a foreign person is not subject to the source maintenance rules.

Under the U.S. Constitution, the more recently adopted of a conflicting treaty and statute generally takes precedence. Thus, a treaty ratified in the future that contains its own source rules arguably might override the source maintenance rules. A preexisting treaty containing such rules would not do so under the later-in-time rule. While under a Code provision in effect since 1936, some statutory taxing rules in effect yield to preexisting treaties, this Code rule applies only in the case of a treaty exclusion from gross income; treaty source rules are not exclusions from gross income. Consistent with these general rules, Congress intended that the new rules maintaining the source of U.S. source income take precedence over any conflicting U.S. treaty provisions in force when it enacted the 1984 Act. Because of a concern that unratified treaties containing source rules arguably conflicting with the 1984 Act source maintenance rule were in an early stage of consideration and could come into force after enactment of the 1984 Act, Congress also intended that the source maintenance rules take precedence over any conflicting U.S. treaties entered into in the future, absent an express intention in the treaty to override the rules.

Explanation of Provision

Under the Act, subject to substantive amendments to the 80/20 rules contained in Title XII of the Act, the foreign title, an 80/20 company is treated as a U.S.-owned foreign corporation and thus is subject to the rules maintaining the source of U.S. source income. The Act thereby prevents U.S. taxpayers from using 80/20 companies to convert U.S. source income to foreign income.

This provision generally took effect on March 28, 1985. In the case of any taxable year of an 80/20 company ending after March 28, 1985, only income received or accrued by the 80/20 company during that portion of the taxable year after that date generally is to be taken into account for purposes of the new source maintenance rules. However, all income received or accrued by the 80/20 company during that taxable year is to be taken into account in determining whether the 10 percent U.S. source earnings and profits threshold for the source maintenance rules is exceeded.

The Act clarifies the applicable CFC definition. Under the Act, an applicable CFC is any controlled foreign corporation in existence on March 31, 1984, the principal purpose of which on that date consisted of (1) any combination of issuing CFC obligations and short-term borrowing from nonaffiliated persons and (2) lending the proceeds to affiliates.

The Act provides that certain U.S. source interest paid to an applicable CFC by an affiliated foreign corporation on an obligation of that corporation issued before June 22, 1984, will be subject to the resourcing provisions to the same extent that interest so paid by an affiliated U.S. corporation would be so subject. This treatment applies if at least 50 percent of the foreign corporation's gross income for the three-year period ending on or before March 31, 1984, and with the close of its taxable year preceding the payment of the interest in question, was effectively connected with a U.S. trade or business.

The Act makes clear that the source maintenance rules apply notwithstanding any contrary U.S. treaty obligation, even those entered into after the Act's date of enactment, unless the treaty clearly expresses an intent to override the rules by specific reference to them. Although Congress found it appropriate to clarify the relation between the source maintenance rules of the Act and the treaty obligations of the United States, no inference contrary to the general rule that gives precedence to the provisions of the Act over preexisting treaty provisions should be drawn with respect to any other provision of the Act (except as specifically provided in the Act or its legislative history). In enacting the 1984 Act, Congress specifically provided that treaties were to prevail over certain statutory rules that apply to stapled stock and to the definition of residence of individuals; with these two exceptions, Congress was not aware of conflicts between the 1984 Act and treaties where the Act would not clearly take precedence. For example, it is Congress's understanding that changes made by the Act in the accumulated earnings tax provisions override a conflicting provision in the U.S. income tax treaty with Jamaica.

The Act contains a targeted transitional rule for carryovers of pre-1984 Act taxes incurred with respect to income that, if earned after the effective date of the 1984 Act, would have been subject to the special separate foreign tax credit limitation contained in section 121(b)(5) of the 1984 Act.

b. Maintaining the character of interest income (sec. 1810(b) of the Act and sec. 904(d)(3) of the Code)

Prior Law

In general

The 1984 Act provided that when a U.S. taxpayer included in income foreign personal holding company or subpart F income with respect to (or an interest or dividend payment from) a designated payor corporation that had earned substantial "separate limitation interest" (generally passive interest income), that inclusion or payment generally constituted interest that was subject to the separate foreign tax credit limitation for interest income.

The purpose of this look-through rule was to prevent U.S. taxpayers from using foreign corporations to inflate the overall foreign tax credit limitation. Prior to the 1984 Act, U.S. taxpayers could arguably circumvent the separate foreign tax credit limitation for interest income by having low-taxed interest income paid to a foreign corporation rather than directly to them. Subpart F and foreign personal holding company inclusions with respect to the foreign corporation, and dividends and interest received from the foreign corporation, were treated as noninterest income of the U.S. taxpayers that was subject to the overall foreign tax credit limitation. As a result of an easily manipulable financial transaction, the conversion of interest income to noninterest income was possible.

Definition of designated payor corporation

The 1984 Act generally defined a designated payor corporation as any regulated investment company, 50-percent (or more) U.S.-owned foreign corporation, or foreign corporation with a ten-percent U.S. shareholder. A domestic corporation that paid foreign source dividends could be a designated payor corporation only if it was a regulated investment company.

A domestic company's dividends (and interest payments) were foreign source if it was an "80/20" company, that is, if it earned less than 20 percent of its gross income from U.S. sources for a three-year period (Code secs. 861(a)(1)(B) and 861(a)(2)(A)).

Code section 269 denies tax benefits to taxpayers who acquire control of corporations to avoid or evade tax. The extent to which section 269 applies to defeat schemes to avoid the Act's look-through rules by using U.S. or foreign corporations is not clear.

10-percent exception

The 1984 Act contained a de minimis rule that prevented characterization of inclusions and payments as interest subject to the separate foreign tax credit limitation for interest income unless 10 percent or more of the earnings and profits of the designated payor corporation was attributable to separate limitation interest. This de minimis rule applied even in the case of income inclusions that arose under the anti-avoidance rules that apply to foreign personal holding companies and controlled foreign corporations.

Related party interest

The 1984 Act provided that when a designated payor corporation received interest from another member of the same affiliated group, the interest was not treated as separate limitation interest unless the interest was attributable (directly or indirectly) to separate limitation interest of the other member.

Working capital exception

Prior to the 1984 Act, investments of working capital in a regulated investment company with a certain level of foreign earnings generated foreign source dividend income that was not subject to the separate limitation for interest. Under the 1984 Act, such dividend payments could be recharacterized as interest payments subject to the separate limitation for interest. Prior to the 1984 Act, certain interest earned on working capital-type investments was excluded from the separate limitation regardless of from whom received: interest was not subject to the separate limitation if derived from any transaction which was directly related to the active conduct by the taxpayer of a trade or business in a foreign country or a U.S. possession (Code sec. 904(d)(2)(A)). The 1984 Act did not allow this working capital exception at the shareholder level for interest received from a regulated investment company or other designated payor corporation by its shareholders. Under the 1984 Act, this working capital exception and the 10-percent de minimis exception referred to above were available at the designated payor corporation level only. Since regulated investment companies earn primarily passive investment income, their income typically could not qualify for these exceptions. Therefore, dividends paid by regulated investment companies generally were treated as interest subject to the separate limitation to the extent that the regulated investment company earned separate limitation interest, whether the recipient shareholder's investment was one of working capital or not.

Explanation of Provisions

The 1986 Act (Title XII) substantially rewrote the provisions dealing with separate limitation interest for taxable years beginning after 1986. The technical corrections to the 1984 Act described below are thus generally superseded by the 1986 Act for those later years.

Definition of designated payor corporation

The Act amends the definition of designated payor corporation in two respects.

First, the Act makes clear that any corporation formed or availed of for purposes of avoiding the look-through rule is treated as a designated payor corporation subject to the rule. For example, U.S. taxpayers are not permitted, in violation of the intent of the look-through rule, to convert interest income to noninterest income by earning the income through a corporation the ownership of which is structured to place the corporation technically outside the present law definition of designated payor corporation: a foreign corporation that earns sufficient earnings and profits attributable to separate limitation interest to be subject to the look-through rule, but is majority-owned by foreign persons and has no ten-percent U.S. shareholders, will be treated as a designated payor corporation (regardless of the original purpose for its formation) if U.S. shareholders utilize the corporation to remove interest income from the separate foreign tax credit limitation for interest income. Similarly, U.S. taxpayers are not permitted, in violation of the intent of the look-through rule, to convert interest income to noninterest income by earning the income through a foreign banking subsidiary or similar entity formed or availed of for that purpose. (Absent this anti-abuse rule, interest earned by a taxpayer in the conduct of a banking or similar business would not be subject to the separate foreign tax credit limitation for interest.) The Secretary may promulgate regulations setting forth appropriate rules for determining whether a corporation has been formed or availed of for purposes of avoiding the look-through rule.

Second, the Act expands the definition of designated payor corporation to include any 80/20 company. By subjecting 80/20 companies to the look-through rule, the Act prevents U.S. taxpayers from using 80/20 companies to circumvent the separate foreign tax credit limitation for interest income.

The first described amendment to the designated payor corporation definition generally takes effect on December 31, 1985. The second described amendment to the designated payor corporation definition generally takes effect on March 28, 1985. In the case of any taxable year of a corporation treated as a designated payor corporation by virtue of these amendments ending after the indicated date, only income received or accrued by the corporation during that portion of the taxable year after that date generally is to be taken into account for purposes of the look-through rule. However, all income received or accrued by the corporation during that taxable year is to be taken into account in determining whether the ten-percent earnings and profits threshold for dividends and interest is exceeded. A corporation formed on or before December 31, 1985, but availed of after that date to avoid the look-through rule, is subject to the rule.

10-percent exception

Consistent with the 1984 Act's rules for source maintenance, the 1986 Act removes the 1984 Act's de minimis rule that prevents maintenance of the character of interest income in the case of foreign personal holding company inclusions and Subpart F inclusions.

Related party interest

The Act makes it clear that when a designated payor corporation receives dividends or interest from another member of the same affiliated group, the amount shall be treated as separate limitation

interest if (and only if) the amount is attributable (directly or indirectly) to separate limitation interest of the other member (or any other member of the group).

Working capital exception

Under the Act, dividends and interest received from a regulated investment company by a portfolio shareholder in such company are not treated as interest subject to the separate limitation for interest if derived from any transaction which is directly related to the active conduct by the shareholder of a trade or business in a foreign country or a U.S. possession. A portfolio shareholder for this purpose is one that owns, directly or indirectly, less than 10 percent of the voting stock of the regulated investment company.

c. Related person factoring income (sec. 1810(c) of the Act and secs. 864 and 956 of the Code)

Prior Law

Investment in U.S. property

Under present and prior law, the Code treats an investment in United States property by a controlled foreign corporation as an effective repatriation of the amount invested and thus as a dividend. The 1984 Act provided that "United States property" includes any trade or service receivable acquired from a related U.S. person if the obligor under the receivable is a U.S. person. This provision overrode exceptions (listed in Code sec. 956(b)(2)) to the investment in U.S. property rules. Among those exceptions is an exclusion from U.S. property of an amount of assets equal to post-1962 earnings and profits previously excluded from subpart F income on the ground that the United States had already subjected those amounts to tax directly as effectively connected income (sec. 956(b)(2)(H)).

Current inclusion of factoring income

The 1984 Act provided that if any person acquires a trade or service receivable from a related person, the acquirer's income from the receivable is treated as interest on a loan to the obligor under the receivable. In general, this income is currently taxable to the owners of the acquirer of the receivable under the foreign personal holding company rules or the controlled foreign corporation rules (subpart F). The income is currently taxable even when the related person that acquires the receivable acquires it from an entity that is organized under the laws of the same foreign country as the acquirer and that has a substantial part of its assets used in its trade or business located in that same country.

Separate limitation treatment

Related person factoring income is treated under the 1984 Act as interest described in section 904(d)(2) and, therefore, is subject to the separate foreign tax credit limitation for interest. Congress intended that this income be ineligible for any exception to application of the separate limitation. However, the 1984 Act does not include in its enumeration of the exceptions the affiliated group exception to that Act's rules maintaining the character of interest income (sec. 904(d)(3)(J)).

Explanation of Provisions

Investment in U.S. property

The Act provides that the existing exclusion from U.S. property of an amount of assets equal to the controlled foreign corporation's post-1962 earnings and profits excluded from subpart F income as effectively connected taxable income will apply in the case of the acquisition of a trade or service receivable that otherwise constitutes U.S. property.

Current inclusion of factoring income

The Act generally exempts factoring income from current inclusion when the related person that acquires the factored receivable acquires it from an entity that is organized under the laws of the same foreign country as the acquirer and that has a substantial part of its assets used in its trade or business located in that same country. Factoring income is still subject to the current inclusion rule, however, if the person transferring the receivable would have derived any foreign base company income (determined without regard to the de minimis exception) or income that is effectively connected with a U.S. trade or business had it collected the receivable.

For example, assume that a controlled foreign corporation manufactures a product in the foreign country of its incorporation and sells the product to an unrelated customer in exchange for the customer's receivable. None of the manufacturer's income is effectively connected with a U.S. trade or business, and none of it would be currently taxable to its U.S. shareholders. The manufacturer sells the receivable to a related controlled foreign corporation that is organized under the laws of the same foreign country. Under the Act, the income of the acquirer from that receivable is not subject to current U.S. taxation.

By contrast, assume that another controlled foreign corporation purchases goods from its U.S. parent and resells those goods to a customer (in exchange for the customer's receivable) for use outside the country of incorporation of the controlled foreign corporation. This income would be currently taxable to the U.S. shareholders of the controlled foreign corporation as foreign base company sales income under the subpart F rules (sec. 954(d)). The controlled foreign corporation sells the receivable to a related controlled foreign corporation that is organized under the laws of the same foreign country as the seller. Under the Act, the income of the acquirer from the receivable remains subject to current taxation at the level of its U.S. shareholders.

The Act's treatment of factoring income also extends to income from analogous loans by a controlled foreign corporation to finance transactions with related parties.

Separate limitation treatment

The Act provides that related person factoring income treated under the Act as interest is subject to the separate limitation for

interest without regard to the exception to the definition of separate limitation interest for certain interest received from members of the same affiliated group. (This substantive result continues under the new separate limitation for passive income contained in the 1986 Act, which is embodied in sec. 864(d)(5)(A)(i).)

d. Repeal of 30-percent withholding tax on portfolio interest paid to foreign persons (secs. 1810 (a) and (d) of the Act and secs. 871, 881, 1441, and 1442 of the Code)

Prior Law

In general

The United States generally imposes a flat 30-percent withholding tax on the gross amount of U.S. source investment income payments to foreign persons. The 1984 Act repealed the 30-percent tax with respect to portfolio interest paid on certain indebtedness by U.S. borrowers to nonresident alien individuals and foreign corporations. This exemption from the 30-percent tax is effective for interest paid on qualifying obligations issued after July 18, 1984, the date of enactment of the 1984 Act.

Registered obligations—non-U.S. person statement

The 1984 Act repealed the 30-percent tax with respect to interest paid on obligations issued in registered form for which the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) receives a statement that the beneficial owner of the obligation is not a U.S. person.

Interest received by controlled foreign corporations

Interest received by a controlled foreign corporation ("CFC") from a person other than a related person may be exempt from the 30-percent tax under the 1984 Act. To prevent U.S. persons from indirectly taking advantage of the exemption, however, the 1984 Act provides that portfolio interest received by a CFC is includible in the gross income of the CFC's U.S. shareholders under subpart F without regard to any of the exceptions otherwise provided under the subpart F rules.

It appears that some interest paid by foreign corporations, which would not have been subject to the 30-percent tax prior to the 1984 Act, nonetheless may fall within the technical definition of portfolio interest. Where such interest is paid to a CFC, treatment of the interest as portfolio interest may subject it to current taxation under subpart F without regard to any of the subpart F exceptions.

Interest received by 10-percent shareholders—attribution rules

Congress did not extend the repeal of the 30-percent tax to interest paid to foreign persons having a direct ownership interest in the U.S. payor because the combination of U.S. deduction and noninclusion in such a case would have created an incentive for interest payments that Congress did not believe appropriate.

A direct ownership interest, for these purposes, generally means a 10-percent (or greater) ownership interest in the U.S. payor. In determining whether direct ownership exists, the stock ownership attribution rules of the Code apply, with certain modifications (sec. 318(a)). One of the applicable attribution rules is that a corporation generally is deemed to own stock that its 50-percent- (or greater) owned subsidiary owns in proportion to the corporation's share of its subsidiary's stock (sec. 318(a)(2)(C)). In determining whether direct ownership exists for purposes of the repeal, this rule is applied without regard to the 50-percent limitation. This modification in the attribution rule prevents an affiliated group of corporations from circumventing the direct ownership exception to the 30-percent tax repeal by, for example, having a U.S. member pay interest to the 49-percent foreign owner of the U.S. member's foreign parent, rather than directly to that foreign parent.

Another of the applicable attribution rules is that a 50-percent- (or greater) owned subsidiary generally is deemed to own the stock that its parent owns (sec. 318(a)(3)(C)). The 1984 Act applies this rule in determining whether direct ownership exists for purposes of the repeal without any modification of the 50-percent limitation. This could allow an affiliated group of corporations to circumvent the direct ownership exception to the 30-percent tax repeal by having a U.S. member pay interest to an affiliated foreign corporation that is as much as 49-percent-owned by a substantial foreign shareholder in the U.S. member, rather than directly to that substantial shareholder.

Explanation of Provisions

Registered obligations—non-U.S. person statement

The Act clarifies that the beneficial owner of a registered obligation, the interest on which is otherwise eligible for the repeal, may claim a refund of any tax withheld where the required non-U.S. person statement is provided after one or more interest payments are made rather than before. Claims for such refunds are subject to the general statute of limitations rules for refund claims (sec. 6511).

Interest received by controlled foreign corporations

The Act amends the definition of portfolio interest to exclude interest that (without regard to the operation of treaties) would not have been subject to the 30-percent tax prior to the Act. Thus, under the Act, interest received by CFCs will be denied the benefit of any otherwise applicable subpart F exceptions only if the interest would have been subject to the 30-percent tax in the absence of the repeal provision.

Interest paid to 10-percent shareholders—attribution rules

In determining whether the direct ownership exception to the 30-percent tax repeal applies, the stock ownership attribution rule of section 318(a)(3)(C) will apply without regard to its 50-percent ownership limitation. Where the attribution rule would not apply but for the disregard of the 50-percent limitation, a foreign interest recipient will be treated as owning the stock its foreign shareholder owns in proportion to that shareholder's ownership interest in the foreign interest recipient.

e. Original issue discount—foreign investors

(1) Deduction for original issue discount (sec. 1810(e)(1) of the Act and sec. 163 of the Code)

Prior Law

The 1984 Act delayed until actual payment the deduction for interest accrued, but not paid, to related foreign lenders with respect to an original issue discount (OID) obligation.

Explanation of Provision

The Act provides that the delay in the timing of deductions for interest accrued but not paid to related foreign lenders with respect to an OID obligation does not apply to the extent that the OID income is effectively connected with the lender's conduct of a U.S. trade or business, unless the OID income is exempt from U.S. taxation or is subject to a reduced rate of tax pursuant to a treaty obligation of the United States.

(2) Taxation of original issue discount (sec. 1810(e)(2) of the Act and secs. 871 and 881 of the Code)

Prior Law

Under the 1984 Act, a foreign investor that receives a taxable interest payment on an OID obligation is taxable on an amount equal to the OID accrued on the obligation since the last payment of interest thereon. On the sale, exchange, or retirement of an OID obligation, the foreign investor is taxable on the amount of any gain not in excess of the OID accruing while the foreign investor held the obligation (to the extent not previously taxed).

Explanation of Provision

The Act provides that when a foreign investor receives a payment (whether constituting interest or principal) on an OID obligation, the amount taxable is equal to the OID accrued on the obligation that has not before been subject to tax, whether or not the OID accrued since the last payment of interest. On the sale, exchange, or retirement of an OID obligation, the foreign investor is taxable on the amount of the OID accruing while the foreign investor held the obligation (to the extent not previously taxed), whether or not that amount exceeds the foreign investor's gain on the sale, exchange, or retirement.

f. Withholding on dispositions by foreigners of U.S. real property interests (sec. 1810(f) of the Act and secs. 897, 1445, 6039C, and 6652(g) of the Code)

Prior Law

In general

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), a foreign investor that disposes of a U.S. real property interest generally is required to pay tax on any gain on the disposition. FIRPTA provided for enforcement of this tax through a system of information reporting designed to identify foreign owners of U.S. real property interests.

The 1984 Act generally repealed the information reporting requirements of FIRPTA and established a withholding system to enforce the FIRPTA tax.[16] The 1984 Act imposes a withholding duty on a transferee of a U.S. real property interest from a foreign person unless the transferee receives a sworn affidavit stating that the transferor is not foreign ("non-foreign affidavit"), or one of four other withholding exemptions (some of which are discussed in more detail below) applies. The amount withheld generally is the lesser of ten percent of the amount realized (purchase price), or the maximum tax liability on disposition (as determined by the IRS). Special rules are provided (some of which are discussed further below) for withholding by partnerships, trustees, executors, distributing foreign corporations, and domestic U.S. real property holding corporations.

Corporations making section 897(i) election

The 1984 Act does not treat foreign corporations electing under Code section 897(i) to be considered domestic corporations for purposes of FIRPTA's substantive and reporting provisions as domestic corporations for withholding purposes. This was intended to simplify the non-foreign affidavit procedure. If the section 897(i) election were applicable for withholding purposes, then electing foreign corporations could provide non-foreign affidavits. Congress was concerned that there would be uncertainty on the part of U.S. buyers regarding the validity of non-foreign affidavits received from foreign corporations.

Since enactment of the 1984 Act, the Internal Revenue Service has developed a procedure that would provide U.S. buyers with reasonable assurance that a non-foreign affidavit received from a foreign corporation is valid (as a result of a valid section 897(i) election) (Temp. Reg. secs. 1.1445-2T(b)(2)(ii), 1.1445-5T(b)(3)(ii)(C), and 1.1445-7T(a)).

Withholding exemptions for transfers of stock in domestic corporations

Withholding is not required on the disposition of an interest (other than an interest solely as a creditor) in a nonpublicly traded domestic corporation if the corporation furnishes a sworn affidavit to the transferee stating that the corporation is not and has not been a U.S. real property holding corporation ("U.S. RPHC") during the base period specified in Code section 897(c)(1)(A)(ii)—the shorter of the period after FIRPTA's general effective date (June 18, 1980) during which the transferor held the interest and the five-year period ending on the date of disposition of the interest ("non-U.S. RPHC affidavit"). The receipt of a non-U.S. RPHC affidavit will not relieve the transferee of withholding responsibility if the

[16] The Act does authorize the Secretary of the Treasury to require information reporting by foreign investors not engaged in a U.S. business that hold direct investments in U.S. real property of $50,000 or more. The Secretary has not exercised that authority and has expressed a current intention not to require information reporting.

transferee has actual knowledge that the affidavit is false or the transferee receives a notice from his or her agent or an agent of the transferor that the affidavit is false.

In addition, no withholding is required on a disposition of shares of a class of corporate stock that is regularly traded on an established securities market.

Notice-giving and withholding responsibilities of agents

A transferor's agent or transferee's agent with actual knowledge that a non-foreign or non-U.S. RPHC affidavit is false must give the transferee notice to that effect at such time and in such manner as the Secretary shall require by regulations. In the case of a foreign corporate transferor, an agent of the transferor is deemed to have actual knowledge that any non-foreign affidavit furnished by the transferor is false. Congress believed that any agent deriving compensation from a foreign corporate principal in a real estate transaction would or should know that his or her principal was in fact foreign and that any non-foreign affidavit furnished by the foreign corporation was, therefore, false. In a case involving the transfer by a foreign corporation of stock in a domestic corporation that furnishes a false non-U.S. RPHC affidavit, it was not Congress' intention that an agent of the foreign corporate transferor be charged with actual knowledge of the non-U.S. RPHC affidavit's falsity, absent actual possession of such knowledge.

A transferor's agent or transferee's agent that does not give the required notice is liable for withholding as if he or she were the transferee, up to the amount of compensation the agent receives in connection with the transaction.

Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates

The 1984 Act requires withholding at a ten-percent rate by a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate with respect to amounts in the custody of the partnership, trust, or estate that are attributable to the disposition of a U.S. real property interest and includible in either the distributive share of a foreign partner of the partnership, the income of a foreign beneficiary of the trust or estate, or the income of the grantor or other substantial owner of the trust (under the grantor trust rules of the Code).

Distributions by domestic U.S. RPHC's

The 1984 Act generally requires withholding by a domestic corporation that is (or, at any time during the five-year or shorter base period specified in section 897(c)(1)(A)(ii), was) a U.S. RPHC when the corporation distributes property to a foreign shareholder in a corporate liquidation or in redemption of its stock. In general, the amount of tax required to be withheld is ten percent of the gross amount of the distribution received by the foreign shareholder.

Withholding is not required under this rule when the stock liquidated or redeemed qualifies for the withholding exemption for stock transferred on an established securities market. Stock qualifying for that exemption may not be a U.S. real property interest and, hence, its surrender may not be a taxable disposition under the FIRPTA rules.

In addition, a qualifying statement granting exemption from withholding under this rule may be requested from the Internal Revenue Service in connection with a liquidating distribution by a domestic corporation of a non-U.S. real property interest when section 337 nonrecognition treatment was not elected for related corporate-level dispositions of U.S. real property interests (made during the base period specified in section 897(c)(1)(A)(ii)) by the domestic corporation. If the section 337 election was not made, the related corporate-level dispositions would have been subject to tax; a foreign shareholder's interest in the liquidating corporation may not be a U.S. real property interest (under the section 897(c)(1)(B) rule excluding from the definition of a U.S. real property interest an interest in a corporation that is not currently holding U.S. real property interests and that was fully taxed on previous corporate-level dispositions of such interests during the section 897(c)(1)(A)(ii) base period). Thus, the foreign shareholder's surrender of his interest in the corporation may not be a taxable disposition under the FIRPTA rules.

Taxable distributions by partnerships, trustees, and executors

The 1984 Act requires withholding by a domestic or foreign partnership, the trustee of a domestic or foreign trust, or the executor of a domestic or foreign estate when the partnership, trustee, or executor makes a distribution of a U.S. real property interest to a foreign person that is a taxable distribution under the FIRPTA rules taxing certain partnership, trust, and estate distributions notwithstanding general Code rules. In general, the amount of tax required to be withheld is ten percent of the fair market value of the distributed U.S. real property interest at the time of the distribution.

As drafted, this rule technically would apply only to U.S. real property distributions taxable under regulations promulgated pursuant to section 897(g). The statute makes no reference to another Code provision added by FIRPTA—section 897(e)(2)(B)—under which certain partnership, trust, and estate distributions not covered by section 897(g) could be treated as taxable sales by regulation.

Return-filing and remittance of tax

To prevent double taxation, the Economic Recovery Tax Act of 1981 directs a person subject to tax under the FIRPTA rules to pay the tax to and file the necessary returns with the United States in the case of real property interests located in the United States, and to pay the tax to and file the necessary returns with the Virgin Islands in the case of real property interests located in the Virgin Islands. A sale of an interest, other than solely as a creditor, in a U.S. RPHC is subject to tax in the United States, while the tax on a sale of an interest in a Virgin Islands real property holding corporation is payable to the Virgin Islands.

Information returns—penalty provision

The FIRPTA information reporting rules include a provision imposing penalties on persons that fail to file required FIRPTA information returns and statements (sec. 6652(g)). As indicated above, the 1984 Act limited the circumstances under which the Secretary could require information reporting. The 1984 Act did not, however, make necessary conforming changes in the penalty provision.

Explanation of Provisions

Corporations making section 897(i) election

Under the Act, a foreign corporation electing under section 897(i) to be treated as a domestic corporation for purposes of FIRPTA's substantive and reporting provisions will be treated as a domestic corporation for purposes of the FIRPTA withholding provisions too.

The Act also provides that the section 897(i) election will be the exclusive remedy for any person claiming discriminatory treatment under a treaty obligation of the United States with respect to the FIRPTA withholding provisions.

Withholding exemptions for transfers of stock in domestic corporations

The Act conforms the non-U.S. RPHC withholding exemption more closely to the underlying substantive tax rule by substituting for it a new "non-U.S. real property interest" exemption to reflect section 897(c)(1)(B). Under the Act, withholding is not required on the disposition of an interest (which is an interest other than solely as a creditor) in a nonpublicly traded domestic corporation if the corporation furnishes an affidavit to the transferee stating, under penalty of perjury, either that the corporation is not and has not been a U.S. RPHC during the base period specified in section 897(c)(1)(A)(ii), or that, as of the date of the disposition, interests in the corporation are not U.S. real property interests by reason of section 897(c)(1)(B). Under section 897(c)(1)(B), interests in a corporation are not U.S. real property interests if the corporation is not holding any U.S. real property interests at the time of the disposition of the corporate interests and if the corporation disposed of all U.S. real property interests it held during the section 897(c)(1)(A)(ii) base period in transactions in which the full amount of gain (if any) was recognized.

The present law rules governing notice-giving by agents and withholding by agents and transferees in the case of a false non-U.S. RPHC affidavit will control (with the clarification discussed below) in the case of a false non-U.S. real property interest affidavit.

Notice-giving and withholding responsibilities of agents

The Act clarifies that an agent of a foreign corporate transferor of a domestic corporation's stock will not be charged with actual knowledge of the falsity of a non-U.S. real property interest affidavit (the Act's substitute for the Act's non-U.S. RPHC affidavit) furnished by the domestic corporation, absent actual possession of such knowledge. Thus, no notice-giving or withholding duty will be imposed on such a transferor's agent unless he or she actually knows that the non-U.S. real property interest affidavit is false. An agent of a foreign corporate transferor will be charged with knowledge of the falsity only of a false non-foreign affidavit furnished by his or her principal.

It should be noted that, under the 1986 Act, unlike the 1984 Act, a non-foreign affidavit furnished by a foreign corporation may be valid. This will be the case where the foreign corporation has elected to be treated as a domestic corporation under section 897(i) and the corporation provides the transferee with proof of the section 897(i) election in the manner specified in regulations.

Dispositions of U.S. real property interests by domestic partnerships, trusts, and estates

The Act modifies the special withholding rule for dispositions of U.S. real property interests by domestic partnerships, trusts, and estates. Under the Act, a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate is to withhold a tax equal to 28 percent of the gain realized on the disposition by the entity of a U.S. real property interest, to the extent that gain is allocable to a foreign partner or foreign beneficiary of the partnership, trust, or estate or, in the case of a trust, is allocable to a portion of the trust treated as owned by a foreign person under the grantor trust rules of the Code. (It is intended that the Secretary of the Treasury will, by regulations, provide an exception from withholding with respect to gain realized on the disposition of a U.S. real property interest by a trust or estate that is currently taxable at the entity level.)

Consistent with the Act's general withholding rule, withholding liability under this special rule, as amended by the Act, is not limited to the gain realized on the disposition that is in the custody of the partnership, trustee, or executor. A partnership, trustee, or executor that does not have sufficient sales proceeds to satisfy its withholding liability (for example, because it mortgaged the disposed-of property on or after acquiring it, or agreed to accept payment for the disposed-of property on an installment basis) may request a qualifying statement from the Internal Revenue Service authorizing it to withhold a lesser amount.

Computing the tax to be withheld as a percentage of gain should, however, result (in many cases) in the collection of an amount of tax that more closely approximates the final tax liability of foreign partners, beneficiaries, and substantial owners than would the amount of tax collected were the tax computed as a percentage of the full amount realized. Withholding on the basis of gain is feasible under this special withholding rule because, unlike the buyer in the usual withholding situation (who may not know the seller's basis), the withholding agent here—a partnership, trustee, or executor—knows what the foreign taxpayer's gain from the disposition will be: the partnership, trustee, or executor itself computes the amount of that gain. The withholding rate reflects the maximum capital gains rate for corporations—the highest rate at which a foreign partner, beneficiary, or substantial owner could be taxed on its share of the gain from the disposition of a U.S. real property interest by a partnership, trust, or estate.

The Act clarifies the Secretary's authority to promulgate such regulations as are necessary to provide for withholding with respect to U.S. real property gains realized by foreign persons

through tiers of domestic partnerships or trusts. The Act also clarifies the Secretary's authority to impose withholding in an administratively workable manner in cases where interests in publicly traded U.S. entities are held by foreign persons through nominees. In such cases, it would be appropriate to require a nominee to withhold from distributions made through that nominee to a foreign interest holder.

These modifications will be effective for dispositions of U.S. real property interests that occur after the day 30 days after the Act's date of enactment.

Distributions by domestic U.S. RPHC's

The Act clarifies that no withholding is required on certain liquidations and redemptions that are not taxed under the substantive FIRPTA rules. It provides that the special rule requiring withholding by domestic U.S. RPHCs (and former domestic U.S. RPHCs) upon the distribution of property in a corporate liquidation or redemption will not apply when interests in the corporation are not U.S. real property interests by reason of section 897(c)(1)(B) on the date of the distribution.

As indicated above, section 897(c)(1)(B) excludes from the definition of a U.S. real property interest an interest in a corporation that (1) is not holding U.S. real property interests at the time the corporate interest is disposed of and (2) disposed of all U.S. real property interests it held during the section 897(c)(1)(A)(ii) base period in transactions in which the full amount of gain (if any) was recognized. If section 897(c)(1)(B) applies to a corporation's stock, a stock interest surrendered in connection with a liquidation or redemption by the corporation is not a U.S. real property interest. Therefore, the surrender of that stock interest is not a taxable disposition under the FIRPTA rules, and withholding on the surrender is inappropriate.

Taxable distributions by partnerships, trustees, and executors

The Act clarifies that a distribution to a foreign person of a U.S. real property interest by a domestic or foreign partnership, trustee, or executor is subject to withholding if such distribution is taxable under any of the substantive FIRPTA rules, not section 897(g) only.

Return-filing and remittance of tax

The Act clarifies that persons required to withhold tax under the FIRPTA withholding rules, like persons having substantive FIRPTA tax liability, are to pay the tax to and file the necessary returns with the United States in the case of real property interests located in the United States, and are to pay the tax to and file the necessary returns with the Virgin Islands in the case of real property interests located in the Virgin Islands.

Information returns—penalty provision

The Act amends the provision (sec. 6652(g)) imposing penalties on persons that fail to file required FIRPTA information returns to conform it with the revised information reporting rules of the Act.

g. Transfers of property to foreign persons pursuant to corporate reorganizations, etc. (sec. 1810(g) of the Act and sec. 367 of the Code)

Prior Law

The 1984 Act added a rule (Code sec. 367(e)) requiring that a domestic corporation recognize gain on a liquidating distribution of appreciated property to any foreign person, under rules similar to those applicable to transfers to foreign corporations. The rules applicable to transfers to foreign corporations were generally restructured under the 1984 Act. The transactions with respect to which Congress intended to require the recognition of gain by a U.S. transferor included certain distributions to foreign persons pursuant to section 355 (relating to distributions of stock and securities of controlled corporations). However, because the applicability of section 355 does not depend on whether the distributee is a corporation, section 367(a)(1) does not reach this result. Section 355 transfers are appropriately addressed under section 367(e), which does not look to the corporate status of the transferee, rather than section 367(a), which applies only to transfers to foreign corporations.

Explanation of Provision

The Act provides that transfers of stock by domestic corporations to foreign persons pursuant to section 355 (or so much of section 356 as relates to section 355) will give rise to the recognition of gain under section 367(e), to the extent provided in regulations. Congress expected that the Secretary would carefully consider the extent to which it is appropriate, in view of the purpose of section 367(e), to require the recognition of gain upon the transfer of the stock of a domestic corporation to foreign persons under section 355.

h. Foreign personal holding companies

U.S. shareholders in a foreign personal holding company are subject to current U.S. tax on their pro rata share of the company's undistributed foreign personal holding company income. The foreign personal holding company rules were enacted (in 1937) to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks."

(1) Same country dividend and interest exception (sec. 1810(h)(1) of the Act and sec. 552 of the Code)

Prior law

The 1984 Act provides that dividends and interest received by a foreign corporation from a person (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that same country generally do not count in determining whether the foreign corporation is a foreign personal holding company. The 1984 Act does not define related person for this purpose.

Explanation of Provision

For the purpose of the 1984 Act's rule excluding same country dividends and interest from the foreign personal holding company calculation, the Act adopts the related party definition of the controlled foreign corporation rules (sec. 954(d)(3)). The effect of this technical correction is to provide that a person is a related person with respect to a foreign personal holding company if the person is (1) an individual, partnership, trust, or estate which controls the foreign personal holding company, (2) a corporation which controls, or is controlled by, the foreign personal holding company, or (3) a corporation which is controlled by the same person or persons which control the foreign personal holding company. For this purpose, prior to the effective date of amendment of Code section 954(d)(3) by section 1221(e) of the Act, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. The Act incorporates certain rules for determining ownership of stock for this purpose.

(2) Interposed foreign entities (sec. 1810(h)(2) of the Act and sec. 551(f) of the Code)

Prior law

The 1984 Act added a tracing rule to the foreign personal holding company rules that was intended to make clear that U.S. taxpayers cannot interpose foreign entities (other than other foreign personal holding companies) between themselves and a foreign personal holding company to avoid the foreign personal holding company rules. Under the tracing rule, stock of a foreign personal holding company that is owned by a foreign entity other than another foreign personal holding company is to be considered (for income inclusion purposes) as being owned proportionately by the foreign entity's partners, in the case of a partnership; owners for tax purposes (i.e., beneficiaries, transferors, or grantors, as the case may be), in the case of a trust; or stockholders, in the case of a corporation.

Explanation of Provision

The Act clarifies that the tracing rule applies to all foreign trusts and estates interposed between U.S. taxpayers and foreign personal holding companies.

i. Treatment of certain indirect transfers (sec. 1810(i) of the Act and sec. 1248(i) of the Code)

Prior law

Code section 1248(a) requires gain realized by certain U.S. persons on the disposition of stock in a foreign corporation to be treated as ordinary income to the extent of allocable earnings and profits of the foreign corporation. Under the 1984 Act, if shareholders of a U.S. corporation exchange stock in the corporation for newly issued stock (or treasury stock) of a foreign corporation ten percent or more of the voting stock of which is owned by the U.S. corporation, the transaction is recast for purposes of applying section 1248. Because the 1984 Act provides that the U.S. corporation is treated as having distributed the stock in the foreign corporation "in redemption" of the shareholder's stock, every indirect transfer could be viewed as a nonliquidating distribution.

The 1984 Act also clarified the treatment of subsequent distributions of earnings that resulted in the recharacterization of gain under section 1248. Taxpayers were given an election to apply this provision retroactively to transactions occurring after October 9, 1975.

Section 1248(g) provides exceptions to section 1248(a) for cases in which gain is taxable as ordinary income under other provisions of the Code. Section 1248(g)(2) refers to any gain on exchanges to which section 356 applies. Under section 356, gain is recognized to the extent of nonqualifying consideration received in a reorganization. Section 356 provides that gain is taxable as a dividend if the exchange has the effect of a dividend, but only to the extent of a shareholder's ratable share of accumulated earnings and profits. If the amount of gain exceeds the allocable portion of earnings and profits, the excess is generally taxed as capital gain.

Explanation of Provision

The Act clarifies that an indirect transfer is recast as a distribution in redemption or liquidation, whichever is appropriate. For example, assume that a U.S. corporation ("P") is the sole shareholder of a U.S. holding company ("Holdco"). Holdco owns 100 percent of the stock of a corporation that was organized under the laws of a foreign country ("S"). Holdco merges downstream into S; in the merger P exchanges Holdco stock for stock of S. Under section 1248(i), the transaction is treated as if Holdco distributed the S stock in a liquidating distribution to P. This result occurs because Holdco goes out of existence and the transaction has the economic effect of a liquidation. Under section 1248(f)(2), however, no amount is includible in Holdco's gross income under section 1248(f)(1), because the S stock is distributed to a domestic corporation, P, which is treated as holding the S stock for the period the stock was held by Holdco and which satisfies the prescribed stock ownership requirements with respect to S. Also, no amount is includible in P's gross income under section 332.

The Act extends the period during which the election relating to previously taxed earnings can be made until one year after enactment of the Act.

The Act also amends section 1248(g)(2) to limit the exception to a shareholder's gain that is characterized as dividend income under section 356.

j. Stapled stock

(1) Collection of tax (sec. 1810(j)(1) of the Act and sec. 269B(b) of the Code)

Prior Law

The 1984 Act treats a foreign corporation whose stock is stapled to that of a U.S. corporation as a U.S. corporation. That corporation is thus taxable on its worldwide income. It is not clear, in some cases, how the United States would collect the tax due under this rule. The 1984 Act requires the Secretary of the Treasury to prescribe such regulations as may be necessary to prevent tax avoidance or evasion through the use of stapled entities.

Explanation of Provision

The Act specifies that the regulations that the Secretary is to prescribe pertaining to stapled entities may include regulations providing that any tax imposed on a foreign corporation that the Act treats as a U.S. corporation may, if that corporation does not pay them, be collected from the U.S. corporation to which it is stapled or from the shareholders of the foreign corporation. For example, assume that all the interests in a foreign corporation are stapled to interests in a U.S. corporation. In that case, regulations may provide that the U.S. corporation is liable for any tax that the foreign corporation does not pay. Alternatively, it could be appropriate to collect the tax from the shareholders of the stapled foreign corporation.

(2) Foreign-owned corporations (sec. 1810(j)(2) of the Act and sec. 269B(e) of the Code)

Prior Law

Under the stapled entity rules of the 1984 Act, a foreign corporation whose stock is stapled to that of a U.S. corporation is treated as a U.S. corporation, whoever owns the two corporations. However, the purpose of the stapled entity rules as applied to foreign corporations was, in general, to prevent avoidance of tax rules that apply to U.S.-controlled foreign corporations.

Explanation of Provision

The Act limits the stapled entity rules treating a foreign corporation as domestic. These rules will not apply if it is established to the satisfaction of the Secretary of the Treasury that both the stapled foreign corporation and the U.S. corporation to which it is stapled are foreign owned. A corporation is foreign owned for this purpose if less than half of its stock, by vote or value, belongs directly or indirectly to U.S. persons.

k. Insurance of related parties by a controlled foreign corporation (sec. 1810(k) of the Act and sec. 954(e) of the Code)

Prior Law

U.S. shareholders of controlled foreign corporations are currently taxable on the foreign base company services income of those corporations. Foreign base company services income is income derived in connection with certain services that satisfy a two-pronged test: (1) they are performed for or on behalf of any person related to the controlled foreign corporation and (2) they are performed outside the country under the laws of which the controlled foreign corporation is organized. For the purpose of the first prong of this test, a related person was generally one with more than 50 percent common ownership. The 1984 Act amended the second prong of the test in the case of insurance services: if the primary insured is a related person (defined more broadly in this case to include a 10-percent U.S. shareholder and persons related to that shareholder), any services performed with respect to any policy of insurance or reinsurance will be treated as having been performed in the country in which the risk of loss against which that related person is insured is located. The 1984 Act did not amend the definition of related person with respect to the first prong of the test.

Explanation of Provision

Provisions in Title XII of the Act prospectively replace the subpart F insurance rules described above. However, for periods of application of the 1984 Act Subpart F insurance rules, the Act makes it clear that there is a single definition of related person for the purpose of determining the amount of foreign base company services income that arises from insurance. In applying the rule that treats income from services performed with respect to insurance or reinsurance for or on behalf of related persons as foreign base company services income (the first prong of the base company services income test), the primary insured will be treated as a related person if it is related within the broad related party rule used specifically for insurance services under the Act—the rule that reaches 10-percent U.S. shareholders and persons related to them.

l. Definition of resident alien (sec. 1810(l) of the Act and sec. 7701(b)(4)(E) of the Code)

Prior Law

Resident aliens, like U.S. citizens, are subject to U.S. tax on their worldwide income at the regular graduated rates. The 1984 Act provided standards for determining whether an individual who is not a U.S. citizen is a resident alien for income tax purposes.

Under these standards, an individual is considered a U.S. resident if the individual has entered the United States as a lawful permanent U.S. resident ("green card test"). In addition, an individual who spends substantial time in the United States in any year or over a three-year period is generally a U.S. resident (the "substantial presence test"). Days spent in the United States as an "exempt individual," a term that includes certain teachers, trainees, and students temporarily present in the United States under subparagraphs (F) and (J) of section 101(15) of the Immigration and Nationality Act, do not count as days of U.S. presence under the substantial presence test. However, a teacher or trainee cannot be an exempt individual in a particular calendar year if the teacher or trainee was exempt as a teacher, trainee, or student for any part of two of the six preceding calendar years. Thus, foreign teachers and trainees may work as such in the United States during no more than two calendar years in any seven calendar-year period without exposing themselves to possible resident alien treatment under the substantial presence test.

In 1961, to relieve foreign students, teachers, and scholars of U.S. tax liability that had the effect of reducing the value of their stipends while they were in the United States, Congress provided that compensation paid by a foreign employer to a nonresident alien individual for the period the individual is temporarily present in the United States as a non-immigrant (under subparagraph (F) or (J) of section 101(15) of the Immigration and Nationality Act) is not subject to U.S. tax (Code sec. 872(b)(3), added by the Mutual Educational and Cultural Exchange Act of 1961). Because foreign teachers and trainees who work as such in the United States during more than two calendar years may become resident aliens under the substantial presence test, some foreign teachers and trainees admitted to the United States under exchange visitor programs during three or four calendar years whose foreign income would otherwise be exempt from U.S. tax under Code section 872(b)(3) were to be subject to U.S. tax on such income received or accrued during their third and fourth calendar years in the United States.

Under the 1984 Act, alien individuals who move to the United States too late in a calendar year to satisfy the substantial presence test for that calendar year were not treated as U.S. residents for any portion of that calendar year (unless they satisfy the green card test for some portion of such year), even if they satisfy the substantial presence test in the following calendar year. Tax benefits accorded to U.S. residents—for example, personal exemptions, joint filing eligibility, and ability to claim itemized deductions—were, therefore, not available to such aliens for any portion of the calendar year in which they moved to the United States.

Explanation of Provision

The Act increases the exemption period for teachers and trainees, all of whose compensation would otherwise be exempt from tax under the Mutual Educational and Cultural Exchange Act, to a maximum of four calendar years. Under the Act, days spent working in the United States as a teacher or trainee during four calendar years in any seven calendar year period do not count as days of U.S. presence for purposes of the substantial presence test if all of the individual's compensation is described in section 872(b)(3).

Under the Act, a qualifying alien individual may elect to be treated as a U.S. resident in a calendar year (the "election year") in which the individual is not otherwise treated as a U.S. resident, if the individual meets the substance presence test for the following calendar year. A qualifying alien individual is one who (1) was not a U.S. resident in the year preceding the election year; (2) is present in the United States for at least 31 consecutive days in the election year; and (3) is present in the United States during the period beginning with the first day of the 31-day presence just referred to and ending with the last day of the election year for a number of days equal to or exceeding 75 percent of the number of days in such period. In applying this 75-percent test, an individual will be treated as present in the United States for up to 5 days during which he or she was actually absent from the country.

A qualifying alien individual who makes the new election will be treated as a U.S. resident only for that portion of the election year which begins on the first day of the earliest presence period for which the individual can satisfy both the 31-day and 75-percent tests described above.

For purposes of both the 75-percent and 31-day tests, an individual will not be treated as present in the United States on any day if the individual is an exempt individual for that day (as determined for purposes of the substantial presence test).

A qualifying alien individual must make the election on his or her tax return for the election year. However, the election may not be made before the individual has met the substantial presence test for the calendar year following the election year. Once an election is made, it remains in effect for the election year unless revoked with consent of the IRS.

The operation of the new election provision is illustrated in the following example: An alien individual vacations in the United States from January 1 through January 31, 1986. He returns to the United States on October 15, 1986, and begins working on a permanent basis for a U.S. company on that day. For the remainder of 1986, he is absent from the country for 10 days only, from December 20 through December 29. He satisfies the substantial presence test in 1987. He was not a U.S. resident in 1985.

The individual may elect to be treated as a U.S. resident for 1986 under the new provision. His residency starting date is October 15, 1986, because that is the first day of the earliest period in 1986 for which both the 31-day and 75-percent tests are satisfied. (The 75-percent test is not satisfied with respect to the presence period commencing on January 1, 1986).

A professional athlete who is temporarily in the United States to compete in one of certain charitable sports events (described in new sec. 274(l)(1)(B)) is treated as an exempt individual for that day, so he or she is not treated as being present in the United States on that day for the substantial presence test. This professional athlete amendment applies to periods after the date of enactment of the 1986 Act, October 22, 1986.

11. Compliance Provisions (sec. 1811 of the Act and secs. 6031, 6050H, 6050K, 6660, and 7502 of the Code)

Prior Law

The 1984 Act contained compliance provisions requiring that:

(1) Recipients of mortgage interest report to the payor and the Internal Revenue Service the amount of mortgage interest received;

(2) Information reporting to the Internal Revenue Service and the taxpayers involved be completed on exchanges of certain partnership interests;

(3) Brokers furnish statements of substitute dividend or tax-exempt interest payments;

(4) A penalty be imposed for substantial underpayments of estate or gift taxes attributable to valuation understatements;

(5) All deposits of $20,000 or more of any tax required to be deposited under the provisions of section 6302(c) of the Code that are made by any taxpayer required to deposit any tax under that section more than once a month must be made by the due date of the deposit, regardless of the method of delivery; and

(6) Partnerships must report to the IRS and provide a copy to the partner of each partner' s share of specific items of income, deductions, and other necessary information so that the partner can complete his or her tax return.

Explanation of Provision

The Act makes the following changes to these compliance provisions:

(1) The Act provides that a cooperative housing corporation must report to both its tenant-stockholder and the Internal Revenue Service on the tenant-stockholder's proportionate share of interest paid to the cooperative housing corporation. The Act also corrects a citation to the Code in the effective date of a related penalty provision.

(2) The Act corrects an internal reference in the provision relating to reporting on exchanges of certain partnership interests.

(3) The Act makes a conforming amendment to section 6678 (relating to penalties for failing to file statements) to include failures to report the substitute payments. The Act also clarifies that the penalty for intentional disregard of the requirement to report these substitute payments to the IRS is 10 percent of the aggregate amount required to be reported.

(4) The Act provides a cross-reference to the definition of underpayment for purposes of the penalty for valuation understatements with respect to estate or gift taxes.

(5) The Act clarifies that the new deposit rules apply to any taxpayer required, under the provisions of section 6302(c), to deposit any tax under that provision more than once a month.

(6) The Act improves information reporting by partnerships where a partner's interest is held by a nominee.

12. Miscellaneous Reform Provisions

a. Tax benefit rule (sec. 1812(a) of the Act and sec. 1511 of the Code)

Prior Law

The 1984 Act amended the rules of prior law to more clearly reflect economic reality in applying the statutory tax benefit exclusion. To accomplish this, the 1984 Act repealed the prior law "recovery exclusion" concept and provided that an amount is excludible from income only to the extent it did not reduce income subject to tax.

Explanation of Provision

The Act provides that an amount is excludible from income only to the extent that it does not reduce a taxpayer's income tax under chapter 1 of the Code. Thus, where a deduction reduces taxable income but does not reduce tax (because, for example, the taxpayer is subject to the alternative minimum tax), recovery of the amount giving rise to the deduction may be excludible from income under section 111. This amendment is not intended to change the result in the example set forth in the committee reports accompanying the 1984 Act.

It is not intended that the current simplified tax benefit computation be changed for individual taxpayers who receive refunds of State and local income taxes. A recomputation of the tax liability for the prior year is expected in these situations only if the taxpayer had no taxable income in the prior year or was subject to the alternative minimum tax or had credits that reduced their tax liability to zero. Other individual taxpayers receiving refunds of State and local income taxes must continue to follow the procedure set forth by the IRS to determine whether their refund should be included in income. This procedure involves a comparison of the refund amount with the amount by which the taxpayer's itemized deductions for the prior year exceeded the zero bracket amount (standard deduction). The lesser of the two amounts is included in income in the current year. This simple procedure, effectively, produces a result comparable to that obtained by the more complicated recomputation of the taxpayer's tax liability for the prior year.

b. Low interest loans (sec. 1812(b) of the Act and sec. 7872 of the Code)

Prior Law

Section 7872 generally provides that certain loans bearing a below-market rate of interest are treated as loans bearing a market rate of interest accompanied by a payment or payments from the lender to the borrower which are characterized in accordance with the substance of the particular transaction, e.g., gift, compensation, dividend, etc.

For purposes of determining the appropriate market rate of interest as well as the timing of the deemed transfers, section 7872 distinguishes between demand loans and term loans. As presently provided by section 7872, a demand loan is defined as a loan which is payable in full at any time on demand of the lender. A term loan is defined as any loan which is not a demand loan. Section 7872(f)(5) provides that the term demand loan includes (for purposes other than determining the applicable Federal rate) any loan which is not transferable and the benefits of the interest arrangements of which is conditioned on the future performance of substantial services by an individual.

For income tax purposes, in the case of a below-market term loan that is not a gift loan or a demand loan, section 7872 treats the excess of the amount loaned over the present value of all payments due under the loan as having been transferred from the lender to the borrower on the date the loan is made. In the case of a below-market demand loan or gift loan, the deemed transfer occurs at the end of each calendar year and the amount of the deemed transfer is the foregone interest for that year.

In applying the prescribed market rate, section 7872 requires semi-annual compounding for non-gift term loans, but does not require semi-annual compounding for gift loans and demand loans.

Section 7872 also provides that withholding by an employer is not required where a deemed payment arising from a below-market

demand loan is in the nature of compensation. However, there is no similar exception from withholding where a deemed compensation payment arises from a below-market term loan.

Under section 7872, a loan to Israel at a below-market rate might be characterized as a loan bearing a market rate of interest accompanied by a non-deductible gift to Israel.

Under section 4941, certain so-called acts of self-dealing between a private foundation and a "disqualified person" are subject to penalty excise taxes on the amount involved. Generally, a loan between the foundation and a disqualified person is an act of self-dealing. However, an exception is provided for interest-free loans to the private foundation, provided that the proceeds of the loan are used exclusively for certain designated charitable purposes.

Explanation of Provision

The definitions of term loan and demand loan in section 7872 appear to treat loans with an indefinite maturity as term loans. However, it often is impractical to treat a loan with an indefinite maturity as a term loan, since section 7872 requires the computation of the present value of the payments due under such a loan. Accordingly, the Act grants the Treasury Department authority to treat loans with indefinite maturities as demand loans rather than term loans.

The Act modifies the special provision of section 7872 that treats certain term loans as demand loans for the purpose of determining the timing of deemed interest and compensation payments.

Under the Act, a loan would be entitled to such treatment if the benefit of the interest arrangement of the loan is not transferable and is contingent upon the performance of substantial future services by an individual. Thus, if a loan satisfies these conditions, it would receive the special treatment even if the lender or the borrower (or either) could transfer the loan.

The various time value of money provisions of the Code, (including provisions relating to the treatment of below-market term loans), generally require the use of semi-annual compounding in calculating interest. In order to treat all loans consistently, the Act provides that semi-annual compounding will also be required in calculating interest with respect to gift loans and demand loans under section 7872.

The Conference Report to the 1984 Act indicated that payments of compensation, deemed to have been made by section 7872, would be subject to the information reporting requirements but not the withholding requirements of the Code.[17] The failure to except from the withholding requirements deemed payments of compensation arising from below-market term loans was inadvertent, and the Act corrects this omission.

The Act also provides an exception from section 7872 for loans to Israel if the obligation is payable in the United States dollars and bears an interest rate of not less than 4 percent.

[17] H. Rep. 98-861, 98th Cong., 2d Sess. 1017 (1984).

Further, the Act clarifies that in enacting section 7872 Congress did not intend to affect the definition of acts of self-dealing with private foundations.

c. Transactions with related persons (sec. 1812(c) of the Act and sec. 267 of the Code)

Prior Law

The 1984 Act generally imposes a matching principle by placing taxpayers on the cash method of accounting with respect to the deduction of amounts owed to a related cash-basis taxpayer. In other words, the deduction by the payor is generally allowed no earlier than when the related payee recognizes the corresponding income.

The application of the above described rule is unclear when the related payee is a related foreign person that does not, for many Code purposes, include in gross income foreign source income that is not effectively connected with a U.S. trade or business.

In addition, the 1984 Act also generally deferred losses on sales of property between corporations which are members of the same controlled group of corporations. An exception was provided for certain sales of inventory to or from foreign corporations.

Explanation of Provision

The Act directs the Secretary of the Treasury to issue regulations applying the matching principle generally applicable to related party transactions in cases in which the person to whom the payment is to be made is not a United States person. For example, assume that a foreign corporation, not engaged in a U.S. trade or business, performs services outside the United States for use by its wholly owned U.S. subsidiary in the United States. That income is foreign source income that is not effectively connected with a U.S. trade or business. It is not subject to U.S. tax (or, generally, includible in the foreign parent's gross income). Under the Act, regulations could require the U.S. subsidiary to use the cash method of accounting with respect to the deduction of amounts owed to its foreign parent for these services. In the case of amounts accrued to a controlled foreign corporation by a related person, regulations might appropriately require the payor's accounting method to conform to the method that the controlled foreign corporation uses for U.S. tax purposes.

Regulations will not be necessary when an amount paid to a related foreign person is effectively connected with a U.S. trade or business (unless a treaty reduces the tax). In that case, prior law already imposes matching. However, regulations may be necessary when a foreign corporation uses a method of accounting for some U.S. tax purposes (e.g., because some of its income is effectively connected), but when the method does not apply to the amount that the U.S. person seeks to accrue.

The Act also provides that the special exception from section 267 for sales of inventory to or from foreign corporations applies where the party related to the foreign corporation is a partnership.

For transfers after September 27, 1985, the Act provides that the provisions of section 707(b)(1)(A) and 707(b)(2)(A) will apply whether

or not the person constructively holding a 50-percent partnership interest was himself a partner. In addition, the Act provides that the deferral provisions of section 267(a)(2) will apply to two partnerships in which the same persons hold a more than 50-percent of the capital interests or profits interests. This rule is intended to replace the rule in the Treasury regulations,[18] which was suggested by the 1984 Committee Reports, relating to transactions between related partnerships with common partners.

A transitional rule is provided for a specified transition where indebtedness was incurred before January 1, 1984.

d. Federal Home Loan Mortgage Corporation ("Freddie Mac") (sec. 1812(d) of the Act, secs. 243 and 246 of the Code, and sec. 177 of the Tax Reform Act of 1984)

Prior Law

General background

The 1984 Act repealed the prior law exemption from Federal income tax of Freddie Mac, effective January 1, 1985. Various transition rules were included to ensure that, to the extent possible, Freddie Mac was subject to tax only on its post-1984 income.

The 12 regional Federal Home Loan Banks, which hold the common stock of Freddie Mac, are themselves exempt from tax; however, the member institutions of the Home Loan Banks are subject to tax.

In a transaction completed in early 1985, Freddie Mac issued a new class of preferred stock in itself to the regional Federal Home Loan Banks, which then transferred the stock to their member institutions. Distributions with respect to this preferred stock will thus be paid directly to the member institutions. The common stock of Freddie Mac continued to be owned by the Federal Home Loan Banks.

Dividends received deduction

The 1984 Act allows shareholders of the Federal Home Loan Banks a dividend received deduction for that portion of dividends received from a Federal Home Loan Bank which is allocable to dividends paid to the Federal Home Loan Bank by Freddie Mac out of Freddie Mac earnings and profits for periods after December 31, 1984. Special "stacking" rules are included in order that a deduction may be received only with respect to dividends which are properly allocable to post-1984 earnings and profits of Freddie Mac. No dividends received deduction is allowed to member institutions for dividends received from Federal Home Loan Banks which are allocable to Freddie Mac earnings and profits which Freddie Mac accumulated before January 1, 1985 (i.e., prior to the date of taxability).

In addition to these rules, the 1984 Act states that, for all income tax purposes, Freddie Mac is to be treated as having no accumulated earnings and profits as of January 1, 1985. This provision was intended to ensure that the deduction for dividends received by member institutions from the Federal Home Loan Banks would

[18] Temp. Reg. Sec. 1.267(a)-2T(c), Questions 2 and 3.

apply only to the extent the dividends are allocable to post-1984 earnings and profits of Freddie Mac (i.e., to Freddie Mac income which has already been subject to tax).

Explanation of Provisions

Dividends received deduction

The Act makes several adjustments in the dividends received deduction for dividends allocable to post-1984 Freddie Mac income.

First, the Act adds an explicit statutory rule stating that no dividends received deduction is to be allowed with respect to dividends paid by Freddie Mac out of earnings and profits accumulated before January 1, 1985 (i.e., the date of taxability). This rule is in addition to the prior law rule which denies a dividends received deduction for dividends paid by a Home Loan Bank which are ultimately allocable to pre-1985 Freddie Mac income. Thus, under the Act, dividends received deductions would be limited to amounts allocable to post-1984 (i.e., taxable) Freddie Mac income, both in the case of income distributed via the Federal Home Loan Banks and in the case of any dividends which may be paid directly to Freddie Mac corporate shareholders who are themselves subject to tax (e.g., member institutions which hold Freddie Mac preferred stock). This rule allows a dividends received deduction where necessary to avoid a double corporate-level tax on Freddie Mac income. In conjunction with this amendment, the prior law rule under which Freddie Mac is treated as having no accumulated profits as of January 1, 1985, is repealed.

Second, in the case of income distributed via a Federal Home Loan Bank, the Act clarifies that no dividends paid by Freddie Mac may serve as the basis for more than one deduction for dividends received from a Federal Home Loan Bank. This clarification applies both to dividends paid by a Federal Home Loan Bank in different years, or when two or more dividends are paid during the same year.

Third, in the case of dividends paid directly by Freddie Mac to taxable corporate shareholders, the Act permits a deduction for dividends received in 1985, as well as later years. This result would otherwise be prevented by a Code provision which denies dividends received deductions for one year after the corporation paying the dividend ceases to be tax-exempt (sec. 246(a)(1)).

Fourth, the Act provides that the earnings and profits of the Federal Home Loan Bank, for purposes of section 246(a)(2), is to be determined as reported in its annual financial statement.

Tax treatment of preferred stock distribution

The Act provides that, for all purposes under the Code, the distribution of preferred stock by Freddie Mac to the Federal Home Loan Banks in late 1984, and the distribution of such stock by the Federal Home Loan Banks to their member institutions in January, 1985, are to be treated as if they were distributions of money in an amount equal to the fair market value of the stock on the date of the distribution by the Federal Home Loan Banks, followed by the payment of such money by the member institutions to Freddie Mac in return for its stock. Thus, under the special rule, the Federal Home Loan Banks will be treated as receiving cash dividends to the extent that the money deemed received from Freddie Mac is attributable to earnings and profits of Freddie Mac, and the earnings and profits of the Federal Home Loan Banks will be increased by an equivalent amount. The member institutions, in turn, will be treated as receiving cash dividends from the Federal Home Loan Banks, to the extent that the money deemed received from the Federal Home Loan Banks is attributable to earnings and profits of the Federal Home Loan Banks (taking into account the earnings and profits resulting from the distribution from Freddie Mac). Because these dividends are allocable to pre-1985 earnings and profits of Freddie Mac, the member institutions will not be entitled to a dividend received deduction with respect to these amounts.

Under the special rule above, the earnings and profits of Freddie Mac will be reduced by the amount deemed distributed to the Federal Home Loan Banks. If Freddie Mac later makes distributions to the member institutions out of its pre-1985 income, these distributions will be treated as dividends (and will not qualify for a dividends received deduction) to the extent (if any) that pre-1985 earnings and profits of Freddie Mac exceeded the amount deemed distributed at the time of the preferred stock distribution.

e. Personal use property (sec. 1812(e) of the Act and secs. 280F and 4064 of the Code)

Prior Law

The 1984 Act provided limitations on the maximum amount of investment tax credit and depreciation that a taxpayer may claim with respect to a passenger automobile. The 1984 Act also provided that if use in a trade or business of listed property does not exceed 50 percent, no investment tax credit is available, and depreciation must be determined on the straight line method over the earnings and profits life of the property. Listed property is any passenger automobile or other means of transportation, any entertainment, recreation, or amusement property, any computer, or any other property specified in regulations. However, any computer used exclusively at a regular business establishment is not considered to be listed property. Employee use of listed property must be for the convenience of the employer and a condition of employment for the employee to be able to claim a deduction or credit for the use of listed property.

Explanation of Provision

The Act clarifies the definition of passenger automobile by providing that the weight of the automobile shall not include the weight of the passengers or the weight of any cargo. Prior law will continue to apply to trucks and vans. A similar clarification is made for purposes of the gas guzzler excise tax (sec. 4064). The amendment to the gas guzzler tax will not apply to any station wagon if the station wagon is a 1985 or 1986 model manufactured before November 1, 1985, and is originally equipped with more than 6 seat belts.

The Act exempts from the gas guzzler tax small manufacturers who lengthen existing automobiles.

The Act also clarifies that the requirements that, in order to take a deduction or credit, employee use of listed property be for the convenience of the employer and required as a condition of employment also apply to the amount of any deduction allowable to the employee for rentals or other payments under a lease of listed property.

The Act also clarifies that computers eligible for the exception from the definition of listed property must be owned or leased by the person operating the business establishment, in addition to being used exclusively at a regular business establishment. See H. Rep. No. 98-861 (June 23, 1984), p. 1026 (Conference Report).

Further, the Act provides that, except to the extent provided in regulations, listed property used as a means of transportation (within the meaning of sec. 280F(d)(4)(A)(ii)) does not include property substantially all the use of which is in the business of providing unrelated persons services consisting of the transportation of persons or property for hire.

B. Technical Corrections to Life Insurance Provisions

1. Certain amounts not less than surrender value of contract (sec. 1821(a) of the Act and sec. 807(c) of the Code)

Prior Law

Prior and present law provide that net increases or decreases in reserves and similar items are taken into account in computing life insurance company taxable income (LICTI). For purposes of computing increases or decreases in life insurance reserves, the amount of the reserve for any contract is the greater of the net surrender value of such contract or a Federally prescribed reserve; the Federally prescribed reserve requires a company to use a particular method for determining the amount of the reserve, the prevailing State assumed interest rate, and the prevailing commissioner's standard mortality or morbidity table.

Among the items for which increases or decreases are taken into account in computing LICTI are amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve, at the time with respect to which the computation is made, life, accident, or health contingencies. For these purposes, the appropriate rate of interest for any obligation is the higher of the prevailing State assumed interest rate as of the time such obligation first did not involve life, accident, or health contingencies or the rate of interest assumed by the company (as of such time) in determining the guaranteed benefit. Prior law did not provide that, in computing increases or decreases in amounts discounted at the appropriate rate of interest, the taxpayer could take into account the net surrender value of the contract if such value was higher than the amount discounted at the appropriate rate.

With respect to determining what method should be used in computing the Federally prescribed reserves for life insurance contracts, the Deficit Reduction Act of 1984 (the "1984 Act") adopted the provision as it was passed by the Senate. In explaining this, the Statement of Managers for the 1984 Act Conference Report expanded the explanation previously made in the Senate report with respect to how annuity reserves should be revalued as of January 1, 1984. In general, the Federally prescribed reserve methods referred to those recommended by the NAIC for the particular type of contract. Thus, in computing any life insurance reserve (including an annuity reserve), a company was to take into account any factors specifically recommended by the NAIC. If specific factors were not recommended by the NAIC prescribed reserve method, the prevailing State interpretation of such method should be considered for purposes of determining what factors can be taken into account in applying the computation method for tax purposes. Because there were divergent State views on how the Commissioners' Annuities Reserve Valuation Method (CARVM, the reserve method prescribed for annuity contracts) should be interpreted, and there was a possibility that the NAIC would act to resolve State differences by the end of 1984, the Statement of Managers indicated that if the NAIC acted in 1984, their recommendations would be given retroactive effect.

The NAIC did not act to resolve the State differences on how CARVM should be applied. Accordingly, annuity reserves should have been revalued as of January 1, 1984, in accordance with the prevailing State interpretation of CARVM. It is understood that, through 1983, the prevailing State interpretation of CARVM was that annuity reserves could be reduced by the amount of any surrender charges (whether or not such charges were contingent). Thus, it was assumed that, failing action by the NAIC in 1984, annuity reserves would be revalued and computed for tax purposes by taking into account any surrender charges.

Explanation of Provision

The Act provides that, in computing the increases or decreases of amounts discounted at interest under insurance and annuity contracts, the amount taken into account will in no case be less than the net surrender value of such contract. This provision recognizes that amounts under these contracts discounted at the prevailing State assumed interest rate may in fact yield a reserve item which is less than the net surrender value guaranteed by the contract. The Act allows the taxpayer to recognize at least its current liability with respect to obligations not involving life, accident, or health contingencies, as represented by the guaranteed net surrender value of a contract. As is the case with life insurance reserves, however, the amounts taken into account cannot exceed the amounts that would be taken into account with respect to such contract as of such time in determining statutory reserves (as defined in sec. 809(b)(4)(B)).

2. Clarification of definition of excess interest (sec. 1821(b) of the Act and sec. 808(d)(1) of the Code)

Prior Law

Under prior law, excess interest was defined as any amount in the nature of interest paid or credited to a policyholder in his capacity as such, and determined at a rate in excess of the prevailing State assumed interest rate for such contract.

Explanation of Provision

The Act changes the definition of excess interest to mean any amount in the nature of interest in excess of the prevailing State assumed rate for such contract. This change is intended to clarify that the term excess interest refers only to the excess amount and not to the entire amount in the nature of interest (including the amount determined at the prevailing State assumed interest rate).

3. Coordination of 1984 fresh start adjustment with certain accelerations of policyholder dividends deductions (sec. 1821(c) of the Act and sec. 808 of the Code)

Prior Law

Prior and present law allow a deduction for dividends or similar distributions to policyholders. Under present law, the amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year. Prior to the 1984 Act, the amount of the deduction was the amount of policyholder dividends paid during the taxable year plus the increases (or less the decreases) in the reserves for policyholder dividends that were payable during the year following the taxable year. Under a transitional rule in the 1984 Act, this change from a reserve to an accrual method was not treated as a change in a method of accounting. Thus, no income or loss was recognized with respect to amounts in existing policyholder dividend reserves, and taxpayers were given a "fresh start" in computing their policyholder dividends deduction.

Explanation of Provision

The "fresh start" under the 1984 Act was granted with respect to the accounting change for policyholder dividends on the assumption that insurance companies would continue to follow their general business practice in declaring policy dividends at the end of the calendar year to be payable on policy anniversaries during the following calendar year only in the event the policy remained outstanding on such anniversary. It was understood that, given the general business practices, the 1984 Act change in policyholder dividends accounting had the effect of delaying the deduction for policyholder dividends to the taxable year in which they are paid.

It appears that by guaranteeing policyholder dividends on termination (which may not necessarily change the payment date of policyholder dividends) or by changing the payment date by making policyholder dividends available upon declaration, a company can accelerate the deduction for approximately one half the policyholder dividends that would have been deducted in the following taxable year if there had been no change in the company's business practices in declaring policyholder dividends. As a practical matter, the amount of the acceleration of the policyholder dividend deduction could be viewed as restoring a company, in part, to the position it enjoyed under prior law with respect to the timing of the policyholder dividends deduction. The "fresh start" for the change in policyholder dividends accounting was intended to mitigate the detriment caused taxpayers by a statutory change in such accounting; to the extent the detriment caused by the statutory change is mitigated in fact by a company's own changed business practices, the "fresh start" was not intended to give a company additional tax benefits.

For these reasons, the Act adopts a provision that would reduce a company's policyholder dividends deduction by the amount by which the company's policyholder dividends deduction was accelerated because of a change in business practices. This reduction for an accelerated policyholder dividends deduction is made before any reduction for the ownership differential provision for mutual life insurance companies and does not exceed on a cumulative basis the amount of a company's 1984 fresh-start adjustment for policyholder dividends. Also, the determination of the amount of the accelerated policyholder dividends deduction and the amount of the 1984 fresh-start adjustment will be made separately with respect to each line of business.

The term "accelerated policyholder dividends deduction" means the amount that would be determined for the taxable year as policyholder dividends paid or accrued, but which would have been determined for a later taxable year under the business practices of the company as in effect at the close of the preceding taxable year. Thus, the types of changes in business practices that would result in an accelerated policyholder dividends deduction include guaranteeing of policyholder dividends on termination for a particular product line or changing the actual payment date of policyholder dividends (for example, by making such dividends available upon declaration). On the other hand, changes in plans of insurance being sold or the development of new products will not be treated as resulting in an accelerated policyholder dividends deduction. For example, the introduction and sale of a universal life insurance product that credits excess interest to the cash surrender value on a monthly basis and that may depart from prior business practices of selling traditional participating life insurance policies that pay policyholder dividends at the policy anniversary date is not the type of change in business practice covered by this provision.

Policyholder dividends paid or accrued on policies issued after December 31, 1983, generally will not produce accelerated policyholder dividends. However, a policy issued after December 31, 1983, in exchange for a substantially similar policy issued before January 1, 1984, is treated as if the policy were issued on the date that the original policy was issued. For this purpose, whether policies are substantially similar is determined without regard to the time of accrual of policyholder dividends. Under this rule, an accelerated policyholder dividends deduction will result if a life insurance company exchanges an old policy for a new policy with substantially similar terms, except that the new policy guarantees policy dividends or makes such dividends available upon declaration.

Under the Act, certain policy exchanges are not treated as exchanges for substantially similar policies. This provision, which exempts policies from the accelerated policyholder dividend provision, applies if the policy is a group policy purchased by an employer under a plan to provide welfare benefits (within the meaning of sec. 419(e)(2)). Similarly, if a company alters the terms of a policy so that the policy does not constitute a welfare benefit fund, such an alteration is not treated as a change in business practice.

The Act specifically provides that this provision does not apply to a mere change in the amount of policyholder dividends. Thus, if a company changes its dividends scale, for example, by increasing the amount of the policyholder dividend over the previous year or by changing the formula for determining the amount of policyholder dividends to include items not previously considered in determining the amount of policyholder dividends (e.g., capital gains),

this provision would not apply to treat such change as an acceleration of policyholder dividends pursuant to a change in business practices.

The cumulative amount of the reduction of a company's policyholder dividends deduction with respect to a particular line of business under this provision is limited to the 1984 fresh-start adjustment for policyholder dividends with respect to such business. Specifically, the 1984 fresh-start adjustment for policyholder dividends means the amounts held as of December 31, 1983, by the company as reserves for policyholder dividends that were deductible in 1983, less dividends that accrued before January 1, 1984. Also, the adjustment amount will be properly reduced to reflect the amounts of previously nondeductible policyholder dividends as determined under prior-law section 809(f).

4. Clarification of equity base (sec. 1821(d) of the Act and sec. 809(b) of the Code)

Prior Law

Under prior and present law, the general rules and definitions relating to policyholder dividends apply to stock and mutual life insurance companies alike, but the amount of the deduction for policyholder dividends for mutual companies is reduced by an amount referred to as the "differential earnings amount." This reduction reflects the concept that, to some extent, policyholder dividends paid by a mutual company are distributions of the company's earnings to the policyholders in their status as owners. The differential earnings amount is computed by multiplying a company's average equity base for the taxable year by a differential earnings rate.

The term equity base means an amount equal to the statutory surplus and capital of a company plus any nonadmitted financial assets, the excess of statutory reserves over tax reserves, the amount of any mandatory securities valuation reserve, deficiency reserve, or voluntary reserve (or similar liability), and 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year.

Explanation of Provision

The Act clarifies that no item shall be taken into account more than once in determining the equity base. This clarification is made to ensure that items which are specifically included in the equity base are not counted a second time because they may be indirectly included under another item which is included in the equity base. For example, deficiency reserves, which are specifically listed in the statute as included in the equity base, could also be included indirectly as part of the excess of statutory policy reserves over tax reserves, which is also specifically included in the equity base.

5. Definition of 50 largest stock companies (sec. 1821(e) of the Act and sec. 809(d)(4) of the Code)

Prior Law

Under prior and present law, the differential earnings amount which reduces a mutual company's policyholder dividends deduction is determined by multiplying the company's average equity base for the taxable year by the differential earnings rate for the taxable year. The differential earnings rate is the excess of an imputed earnings rate over the average mutual earnings rate. The imputed earnings rate is set in the Code and subsequently adjusted to provide comparable treatment for stock and mutual companies.

For taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance companies for the 3 years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983). The 50 largest stock companies are to be determined by the Secretary of the Treasury on the basis of gross assets; for these purposes, assets of a company among the 50 largest will be aggregated with assets of any affiliated life companies. However, under prior law, in order to eliminate distortions in the computation of the average earnings rate of the 50 largest stock companies, the Secretary would have had the authority to omit from such computation companies with aberrational rates caused by disproportionately small equity bases (for example, when a company is close to being, or is, insolvent).

Explanation of Provision

The Act modifies the authority of the Secretary of the Treasury to issue regulations that would exclude companies from the 50 largest stock companies. Under the Act, any company that has a negative equity base is excluded from the 50 largest stock companies. In addition, regulations could exclude additional companies from the 50 largest stock companies if the exclusion of those companies would, by reason of their small equity bases, seriously distort the stock earnings rate. An unlimited number of stock companies could be excluded from the group by reason of their having a negative equity base. However, no more than two companies could be excluded from the group of 50 largest stock companies by reason of the fact that their earnings rate could seriously distort the stock earnings rate. In addition, distorting companies could be excluded from the group of 50 largest stock companies only if their exclusion, in addition to the exclusion for the negative equity companies, would not cause the total number of stock companies to be excluded to exceed two.

The Act provides that a company will be removed from the group of 50 largest stock companies for the base period if such company had a negative equity base at any time during 1981, 1982, or 1983.

The Act further provides that only domestic stock companies (not branches of foreign life insurance companies) are included in the determination of the 50 largest stock companies. Similarly, the Act provides that the calculation of the average mutual earnings rate is based on the gain or loss from operations of domestic mutual life insurance companies (not branches of foreign life insurance companies).

6. Clarification of statement gain or loss from operations (sec. 1821(f) of the Act and sec. 809(g)(1) of the Code)

Prior Law

Under prior and present law, the earnings rate for any life insurance company is the percentage, determined by the Secretary of the Treasury, which a company's statement gain or loss from operations is of its average equity base. Prior law provided that the term "statement gain or loss from operations" meant the net gain or loss from operations required to be set forth in the annual statement (a) determined with regard to policyholder dividends (as defined in section 808), but without regard to Federal income taxes, (b) determined on the basis of tax reserves rather than statutory reserves, and (c) properly adjusted for realized capital gains or losses and other relevant items.

Explanation of Provision

The Act revises the definition of statement gain or loss from operations to clarify that the term refers to net gain or loss from operations set forth in the annual statement, determined without regard to Federal income taxes and with further adjustment for certain items. Specifically, the Act clarifies that the "statement gain or loss from operations" must be adjusted by substituting for the amount shown on the annual statement for policyholder dividends the amount of the deductions for policyholder dividends under section 808, before reduction by any differential earnings amount (i.e., without regard to sec. 808(c)(2)). The use of the tax amount for the policyholder dividends deduction unreduced by any differential earnings amount is necessary to eliminate a circularity in computation of the differential earnings amount and to ensure that subsequent adjustments in the differential earnings amount have the revenue impact intended by the ownership differential provision.

7. Effect of differential earnings amount on estimated tax payments (sec. 1821(g) and (h) of the Act and sec. 809(c) and (f) of the Code)

Prior Law

Under prior and present law, the differential earnings amount which reduces a mutual company's policyholder dividends deduction is determined by multiplying a company's average equity base for the taxable year by the differential earnings rate for the taxable year. The differential earnings rate is the excess of an imputed earnings rate over the average mutual earnings rate. The imputed earnings rate is set in the Code and subsequently adjusted to provide comparable treatment for stock and mutual companies.

The differential earnings rate for the taxable year is published by the Secretary of the Treasury after all the relevant data and computations have been made.

The differential earnings amount for any taxable year is recomputed when sufficient tax return information is available to determine the average mutual earnings rate for the calendar year in which the taxable year begins. Thus, the recomputed differential earnings rate for 1984 is determined after the tax returns for 1984 are filed, and is based on the average mutual earnings rate for 1984. If the recomputed differential earnings amount computed with respect to a given taxable year exceeds the differential earnings amount reported on the company's tax return for that year, then the excess is required to be included in taxable income in the succeeding taxable year (1985, with respect to the recomputed differential earnings rate for 1984). Similarly, if the recomputed differential earnings amount computed with respect to a taxable year is less than the differential earnings amount reported for that year, then the difference will be allowed as a deduction in the subsequent taxable year.

Explanation of Provision

The Act amends the definition of the differential earnings rate to be used for a taxable year solely for purposes of estimated tax payments. Specifically, the Act provides that if, with respect to any installment of estimated tax, the differential earnings rate for the second preceding year is less than the differential earnings rate applicable to the taxable year for which the installment is paid, then for purposes of applying additions to tax for underpayments of estimated tax with respect to such installment, the amount of tax shall be determined by using the differential earnings rate for such earlier year.

In providing this relief from additions to tax for underpayments of estimated tax under these limited circumstances, Congress recognized that, as a practical matter, the Secretary of the Treasury will be unable to collect the data from the previous taxable year and compute the new differential earnings rate for the current taxable year in time for the taxpayer to use that differential earnings rate to make its initial estimated tax payments.

The Act also clarifies that the recomputation of the differential earnings amount with respect to any taxable year will not affect the liability for estimated tax payments for the taxable year in which the recomputed amount is included in (or deducted from) income. Thus, a mutual company will compute its tax liability for 1984 by using the statutory transitional differential earnings rate of 7.8 percent. If the recomputed differential earnings rate for 1984 exceeds 7.8 percent, then the company will be required to include in income in 1985 the excess of the recomputed differential earnings amount over the differential earnings amount reported on its tax return. As a practical matter, Treasury will be unable to collect the data for 1984 and compute the 1984 rate before 1986. Accordingly, this excess will not affect the company's estimated tax liability, or penalties relating to that liability, for 1985.

8. Amendments related to proration formulas (sec. 1821(i) of the Act and sec. 812 of the Code)

Prior Law

Prior and present law retain the concept that items of investment yield should be allocated between policyholders and the company. Because reserve income increases may be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The policyholders' share of any item is 100 percent of the item reduced by the company's share of the item. The company's share is defined as the percentage obtained by dividing the company's share of net investment income by total net investment income. Net investment income is defined as 90 percent of gross investment income. Gross investment income is generally all income from investments, including tax-exempt interest, and not including 100-percent dividends except to the extent such dividends are paid directly or indirectly out of tax-exempt income.[1] The definition of net investment income as 90 percent of gross investment income was believed to reflect generally the historical level of industry investment expenses.

The company's share of net investment income is the excess of net investment income over the sum of: (1) required interest (at the prevailing State assumed rate) for reserves; (2) the deductible portion of any excess interest; (3) the deductible portion of any amount in the nature of interest (whether or not a policyholder dividend) credited to a policyholder or customer fund under a pension plan contract for employees not yet retired or to a deferred annuity contract before the annuity starting date and not taken into account in (1) or (2); and (4) a fraction (referred to as the "minifraction") of the deductible portion of policyholder dividends (not including the deductible portion of any amounts previously included under (1), (2), or (3), and not including the deductible portion of any premium or mortality charge adjustments associated with a contract for which excess interest was credited during the taxable year).

The deductible portion of any policyholder dividend is that portion remaining after a pro-rata reduction of all policyholder dividends by the differential earnings amount under section 809 (if applicable). The fraction of the deductible portion of policyholder dividends to be included is determined by applying the minifraction. The numerator of the minifraction is gross investment income (including tax-exempt income), less required interest, excess interest and the amounts credited to pension plan contracts and deferred annuities (items (1), (2), and (3) described above). The denominator of the minifraction is gross income (including tax-exempt income), less net increases in reserve items.

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[1] 100-percent dividends are those which would be eligible for the 100-percent dividends-received deduction, assuming the recipient is not a foreign corporation.

Explanation of Provision

The Act amends the definition of required interest to provide that, if the prevailing State assumed interest rate is not used, another appropriate rate is to be used in calculating required interest.

Under the Act, the definition of the company's share of net investment income is amended to clarify that, in arriving at such amount, net investment income should be reduced by all interest paid to a depositor or any customer for the services provided by the life insurance company, whether it is interest guaranteed on the contract (like required interest) or excess interest. For example, net investment income should be reduced by all interest paid on deposit administration contracts that provide no permanent purchase rate guarantees; although the purchaser of such a contract may not technically be a "policyholder," the purchaser may be viewed as a depositor or a customer for the services provided by the life insurance company.

The Act eliminates a circularity problem existing under the language of prior law in determining the minifraction to be used for purposes of computing the gross investment income's proportionate share of policyholder dividends. Specifically, the Act redefines the denominator of the minifraction to be life insurance gross income reduced by the excess (if any) of the closing balance for the reserve items described in section 807(c) over the opening balance for such items for the taxable year. It further generally states that, for purposes of computing the denominator, life insurance gross income shall be determined by including tax-exempt interest (as under present law) and by computing any decreases in reserves without any reduction of the closing balance of the reserve items by the company's share of tax-exempt interest.

In addition, the Act refines the definition of net investment income to take into account the fact that investment expenses with respect to assets held in segregated asset accounts have historically been smaller than those with respect to general account assets. Accordingly, in the case of gross investment income attributable to assets held in segregated asset accounts underlying variable contracts, the Act defines net investment income to mean 95 percent, rather than 90 percent, of gross investment income.

Further, for purposes of computing net increases or decreases in reserves and for purposes of the proration formula, the Act provides that the terms "gross investment income" and "tax-exempt interest" shall not include any interest received with respect to a securities acquisition loan (an ESOP loan) as defined in section 133(b). Also, for purposes of determining the gross investment income's proportionate share of policyholder dividends, "life insurance gross income" shall not include the interest on a securities acquisition loan. This amendment more fully implements the intention of Congress when it provided an exclusion from gross income for 50 percent of the interest received on a securities acquisition loan, that is, to encourage financial institutions to make loans to ESOPs and to employers who maintain leveraged ESOPs.

9. Treatment of foreign life insurance companies (sec. 1821(j) of the Act and sec. 813(a) of the Code)

Present Law

In general, under present law, foreign corporations are subject to U.S. tax only on certain U.S.-source income and on income that is effectively connected with a trade or business conducted in the United States. A foreign corporation carrying on an insurance business within the United States, which would qualify as a life insurance company if it were a U.S. corporation, is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any U.S. trade or business. The determination of whether a foreign corporation would qualify as a life insurance company considers only the income of the corporation that is effectively connected with the conduct of its business carried on in the United States.

A special rule alters the U.S. tax on foreign life insurance companies doing business in the United States if they hold a relatively small surplus in the United States. If a foreign life insurance company's surplus held in the United States is less than a specified minimum amount, then the company must increase its income by the product of (1) the excess of the required minimum surplus over actual surplus, and (2) its current investment yield.

Explanation of Provision

The Act clarifies how a foreign life insurance company doing business in the United States should compute its life insurance company taxable income if additional income has been imputed because actual surplus held in the United States is less than the required minimum surplus. Specifically, any amount of income imputed by the special adjustment to income under section 813 shall be added to life insurance gross income (before computing the amount of the special life insurance company deduction and the small life insurance company deduction), and such increase in income shall be included in gross investment income.

10. Treatment of certain distributions to shareholders from pre-1984 policyholders surplus account (sec. 1821(k) of the Act and sec. 815 of the Code)

Prior Law

In general, the 1984 Act eliminated any further deferral of tax through additions to a policyholders surplus account with regard to income for 1984 and later years. Although companies are not able to enlarge their policyholders surplus account after 1983, they will not be taxed on previously deferred amounts unless such amounts are treated as distributed to shareholders or are subtracted from the policyholders surplus account under rules that are comparable to those provided under the 1959 Act, but that reflect the basic changes in the tax structure under the 1984 Act.

Prior and present law provide that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of distribution. For these purposes, the term distribution includes actual or constructive distributions.[2] When there are distributions from the policyholders surplus account, the amount of the distribution (whether actual or deemed, or the indirect use of amounts in the policyholders surplus account for the benefit of shareholders) is taxed in addition to life insurance company taxable income (LICTI) and not as part of the LICTI computation. Thus, distributions from the policyholders surplus account cannot be offset by life insurance company losses and are not subject to the special and small life insurance company deductions.

Explanation of Provision

The citation in the legislative history of the 1984 Act to *Union Bankers Insurance Company* indicated the type of fact situations in which liability for a tax on distributions from a policyholders surplus account could arise. The 1984 Act emphasis on taxing both direct and indirect distributions from the policyholders surplus account was intended to be construed more broadly than under the 1959 Act, causing certain uses of policyholders surplus account funds to be treated as a distribution therefrom, whether or not there was a distribution under general corporate tax provisions.

The Act clarifies what would constitute an indirect distribution from the policyholders surplus account by providing that a direct or indirect distribution does not include a bona fide loan with arm's-length terms and conditions. An indirect distribution will be treated as occurring whenever policyholders surplus account funds are used to benefit the shareholders indirectly. For example, this may occur by using such funds to purchase stock of a parent or an affiliated company or by using such funds to make loans within an affiliated group for less than adequate consideration. Whether or not a loan is made with arm's-length terms and conditions may be determined by reference to section 482 (relating to the allocation of income and deductions among taxpayers) and the regulations thereunder.

In the case of any loan made before March 1, 1986, the amount that will be treated as an indirect distribution from the policyholders surplus account due to the absence of arm's length terms and conditions will be limited to the foregone interest on the loan. The amount of foregone interest will be determined by using the lowest rate which would have met the arm's length requirements for a loan with the same terms and conditions. This rule continues to apply unless the loan is renegotiated, extended, renewed, or revised on or after March 1, 1986.

The Act also reinstates a prior law provision (section 819(b)) which provides rules applicable to distributions from policyholders surplus accounts of foreign life insurance companies doing business in the United States.

[2] See *Union Bankers Insurance Company* v. *Commissioner*, 64 T.C. 807 (1975).

11. Treatment of deficiency reserves (sec. 1821(l) of the Act and sec. 816 of the Code)

Prior Law

Because of a general change in State law, as well as new rules for computing tax reserves, a provision that had specifically excluded deficiency reserves from the definition of life insurance reserves and total reserves was eliminated under the 1984 Act. The prior-law rules for computing tax reserves prohibited a company from taking into account any State requirements for "deficiency reserves" caused by a premium undercharge for purposes of computing the company's increases or decreases in life insurance reserves.

Explanation of Provision

The Act reinstates the exclusion of deficiency reserves from the definition of life insurance reserves and total reserves solely for purposes of section 816, which defines a life insurance company, and section 813(a)(4)(B), which defines surplus held in the United States for foreign life insurance companies doing business in the United States. The treatment of deficiency reserves under the 1984 Act was not intended to have a substantive effect on the qualification of a company as a life insurance company or on the computation of surplus held in the United States for foreign life insurance companies.

12. Treatment of certain nondiversified contracts (sec. 1821(m) of the Act and sec. 817(h) of the Code)

Prior Law

Prior and present law provide special rules for variable life insurance or annuity contracts, or pension plan contracts with reserves based on segregated asset accounts (generally referred to as variable contracts). In addition to the rules for separate accounting with respect to variable contracts, prior and present law grant the Secretary of the Treasury regulatory authority to prescribe diversification standards for investments of segregated asset accounts underlying variable contracts.

In addition, prior and present law include specific statutory diversification guidance for segregated accounts that are at least as diversified as regulated investment companies (if no more than 55 percent of assets are held in cash items, government securities, and securities of regulated investment companies), for variable life insurance contracts based on investments in Treasury securities, and for segregated accounts using investment funds that are not available to the public. If a segregated asset account underlying a variable contract does not meet the prescribed diversification standards, the contract will not be treated as an annuity or as life insurance for tax purposes.

Under prior and present law, the beneficial interest in a regulated investment company is not treated as one investment if all of the beneficial interests in such company or trust are held by one or more segregated asset accounts of one or more insurance companies. Thus, a segregated asset account is treated as owning a pro-rata share of the underlying investments in the regulated investment company or trust.

Explanation of Provision

The Act clarifies the exception for variable life insurance contracts based on investments in Treasury securities. Generally, the investments made by any segregated asset account with respect to a variable life insurance contract will be treated as adequately diversified to the extent invested in securities issued by the United States Treasury. Congress intends that the Treasury Department, in issuing regulations relating to the adequate diversification requirement, will provide guidance as to how the diversification requirement applies to the assets of the segregated asset account that are not invested in securities issued by the United States Treasury.

In addition, the Act provides that, if all the beneficial interests in a regulated investment company or any trust are held by one or more (a) insurance companies (or affiliated companies) in their general account or in segregated asset accounts, or (b) fund managers (or affiliated companies) in connection with the creation or management of the regulated investment company or trust, the diversification requirements shall be applied by taking into account the assets held by such regulated investment company or trust. This revision of the prior law "look through" rule generalizes and broadens the statutory language to allow for the ownership of fund shares by an insurance company or fund manager for administrative convenience, in operating an underlying investment fund.

Congress intends that, for purposes of determining whether a variable contract is adequately diversified, the types of situations grandfathered in Rev. Ruls. 77-85, 80-274, and 81-225 will continue to be grandfathered under Treasury regulations. Further, Congress expects the Treasury Department to provide a reasonable time after issuance of regulations relating to the diversification requirements during which an insurance company that relied on private letter rulings issued under the guidelines of those revenue rulings can diversify the assets of a segregated asset account.

13. Treatment of certain deferred compensation plans (sec. 1821(n) of the Act and sec. 818(a)(6)(A) of the Code)

Prior Law

Under prior and present law, diversification requirements prescribed by Treasury for segregated asset accounts underlying variable contracts do not apply with respect to pension plan contracts. Pension plan contracts refer generally to contracts used for qualified pension, profit-sharing, and stock bonus plans, qualified annuity plans, individual retirement accounts, or governmental plans (within the meaning of sec. 414(d)) which provide retirement benefits.

Explanation of Provision

The Act clarifies the definition of a pension plan contract to include an eligible State deferred compensation plan (within the meaning of sec. 457(b)).

14. Dividends within affiliated group (sec. 1821(o) of the Act and sec. 818(e) of the Code)

Prior Law

In addition to the general rules applicable to affiliated groups filing consolidated returns, prior and present law provide a specific rule that, if an election to file a consolidated return is in effect with respect to an affiliated group for the taxable year, all items of the members of such group which are not life insurance companies shall not be taken into account in determining the amount of the tentative LICTI of members of such group which are life insurance companies.

Prior law, as adopted under the 1984 Act, omitted a pre-1984 Act provision (prior law sec. 818(f)(1)) that provided a special rule for a life insurance company filing or required to file a consolidated return. Generally, this provision required that a company compute its policyholders' share of investment yield as if such company were not filing a consolidated return.

Explanation of Provision

The Act reinstates the prior-law provision of section 818(f)(1) with minor modifications to reflect changes in the general tax structure for life insurance company taxation. The Act provides that, in the case of a life insurance company filing or required to file a consolidated return with respect to any affiliated group for any taxable year, any determination under part I of subchapter L with respect to any dividend paid by one member of such group to another member of such group shall be made as if such group were not filing a consolidated return. This reinstatement of the prior-law provision is necessary to maintain the integrity of the proration rule for tax-exempt interest and the intercorporate dividend deduction between policyholders and the company.

15. Treatment of dividends from subsidiaries (sec. 1821(p) of the Act and sec. 805(a)(4) of the Code)

Prior Law

In general, under prior and present law, the deduction for intercorporate dividends received by a life insurance company is prorated between the company and the policyholders in proportion to the company's share and the policyholders' share of net investment income. However, "100 percent dividends" generally are not subject to proration except to the extent that they are attributable to tax-exempt interest or dividends that would not qualify as 100 percent dividends in the hands of the taxpayer. Under prior law, this limited proration of "100 percent dividends" applied whether the corporation making the distribution was a life insurance company or a corporation not taxed as a life insurance company.

Explanation of Provision

The Act adds a special rule in the case of certain 100 percent dividends received from a life insurance subsidiary. Under the Act, in the case of any 100 percent dividend paid to a life insurance company for any taxable year after December 31, 1983, by another life insurance company, a portion of the deduction under sections 243, 244, or 245(b) (as the case may be) is disallowed if the payor company's share determined under the proration rules exceeds the payee company's share for the payee company's taxable year in which the dividend is received or accrued.

The portion of the deduction that is disallowed is the percentage obtained by subtracting the payee company's share from the payor company's share multiplied by the portion of the dividend attributable to prorated amounts. Prorated amounts include tax-exempt interest income and dividends other than 100 percent dividends.

In determining the portion of a dividend attributable to prorated amounts, any dividend by the payor company is treated as coming first out of earnings and profits for taxable years beginning after December 31, 1983, attributable to prorated amounts. In addition, the portion attributable to prorated amounts is calculated by determining the portion of earnings and profits attributable to prorated amounts without any reduction for Federal income taxes.

In addition, the Act provides that similar rules apply in the case of 100 percent dividends paid by an insurance company which is not a life insurance company. Thus, for example, similar rules apply where a life insurance company receives a 100 percent dividend from a property and casualty insurance company.

16. Special rule for application of high surplus mutual rules (sec. 1821(q) of the Act and sec. 809(i) of the Code)

Prior Law

The 1984 Act provided a 5-year transition rule for high surplus mutual life insurance companies for purposes of applying the ownership differential provision. Under prior law, a company was a high surplus company if its equity base to asset ratio for 1984 exceeded a specified percentage of assets. Under prior and present law, a high surplus company need not apply the differential earnings rate to the excess portion of its equity base. The amount of any excess equity not taken into account in applying the differential earnings rate decreases ratably each year until 1989 when the entire equity base of a high surplus company is subject to the differential earnings rate. The amount of excess equity taken into account by any mutual life insurance company for any year (before being phased down ratably over the 5-year period of the transitional rule) cannot exceed the amount of the excess equity determined for 1984.

For purposes of determining whether a company is a high surplus company, the assets taken into account in the equity to asset ratio include all assets (e.g., certain nonadmitted assets) taken into account in determining its equity base including any additional equity attributed to the mutual because of the rules for the treatment of stock life companies owned by mutual life insurance companies. Thus, all the assets of any life insurance subsidiary whose equity is included in equity of the parent mutual company, as well as any assets of separate asset accounts, are included in assets for purposes of applying the high surplus transitional rule.

Explanation of Provision

Under the Act, in the case of any mutual life insurance company that was incorporated on February 23, 1888, and acquired a stock subsidiary during 1982, the amount of the company's excess equity base for its first taxable year beginning in 1984, for purposes of the high surplus mutual company rule, is $175 million. This provision applies without regard to any other provision that would otherwise limit the company's excess equity base.

17. Changes in tables for contracts for which there are no commissioners' standard tables (sec. 1821(s) of the Act and sec. 807(d)(5)(C) of the Code)

Prior Law

Under prior and present law, the amount of the reserve for any contract is determined by using the tax reserve method applicable to the contract, the prevailing State assumed interest rate, and the prevailing commissioners' standard tables for mortality and morbidity (with certain adjustments). The term "prevailing commissioners' standard tables" generally means the most recent such tables permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued. If there are not commissioner's standard tables applicable to any contract when it is issued, the mortality and morbidity tables used for this purpose are to be determined under regulations prescribed by the Secretary of the Treasury.

Explanation of Provision

The Act clarifies that when the Secretary of the Treasury by regulations changes tables applicable to certain contracts (for which there are no commissioners' standard tables) by regulations, the new table is treated as a new prevailing commissioner's standard table adopted by the 26th State as of a date specified in the regulations. This clarification has the result that changes to tables set forth in regulations have the same statutory effect as tables originally set forth in regulations, and the same statutory effect as actual prevailing commissioners' standard tables.

18. Treatment of certain contracts as variable contracts (sec. 1821(t) of the Act and sec. 817(d) of the Code)

Prior Law

Prior and present law provide special treatment in the case of variable contracts for increases and decreases in reserves and adjustments to the basis of assets held in a segregated asset account. A variable contract is defined to mean a contract meeting certain requirements, including the following requirements: (1) in the case of an annuity contract, the amounts paid in or out reflect the investment return and the market value of the segregated asset account, or (2) in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account.

Explanation of Provision

The Act clarifies the definition of a variable contract to provide that variable life insurance or variable annuity contracts with guarantees are treated as variable contracts. In the case of such contracts with guarantees, the requirements relating to investment return and market value of the segregated asset account are applied without regard to whether there is a guarantee. The Act further provides that obligations under such a guarantee that exceed obligations under the contract without regard to the guarantee are accounted for as part of the company's general account (i.e., not as part of a segregated account).

Effective Date

The provision applies to contracts issued after December 31, 1986, and to contracts issued before January 1, 1987, if such contract was treated as a variable contract on the taxpayer's income tax return.

19. Clarification of denial of fresh-start provisions, application of 10-year spread, and the effect of fresh start on earnings and profits (secs. 1822 (a), (d), and (e) of the Act and secs. 216(b)(1) and 216(b)(3)(A) and (C) of the 1984 Act)

Prior Law

Under the 1984 Act, life insurance companies were required to revalue their reserves as of the beginning of the first taxable year beginning after December 31, 1983, according to newly prescribed reserve computation rules. Generally, any change in method of accounting or any change in the method of computing reserves which was required by the provisions in the 1984 Act was not to be treated as a change in method of accounting or in the method of computing reserves and thus not to give rise to income or loss. This gave life insurance companies a "fresh start" with respect to computing their life insurance reserves.

However, the fresh-start provision did not apply to any reserve transferred pursuant to a reinsurance agreement entered into, or a modification of a reinsurance agreement made, after September 27, 1983 (the date the fresh start provision was adopted by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee) and before January 1, 1984 (the effective date of the new provisions). Likewise, the fresh start benefits did not apply to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984. For these purposes, the phrase "any reserve strengthening" included the computation of reserves on contracts issued in 1983 at an interest rate that was lower than the rate normally assumed in computing reserves for similar contracts.

Further, under the 1984 Act, in the case of any item to which the fresh start had been denied, such item was taken into account for the first taxable year beginning after December 31, 1983 (in lieu of over the 10-year period otherwise provided), unless the item was required to have been taken into account over a period of 10 taxable years under pre-1984 Act law.

Explanation of Provision

The Act clarifies that, with respect to reserves for which the fresh start was denied under the 1984 Act, the rule for spreading a change in basis of computing reserves over a 10-year period will be applied to the extent that the reserve change would have been required to be taken into account over a 10-year period under pre-1984 Act law. With respect to reserves for which the fresh start has been denied, that portion of the reserve change attributable to the repeal of an election under 818(c) is taken into account in the first taxable year beginning after December 31, 1983, and is not spread over a 10-year period.

In addition, the Act conforms the closing date for the period for which proscribed reinsurance transactions will result in a denial of the "fresh start" to that date given for revaluation of reserves. Specifically, the Act provides that, for purposes of the denial of fresh start provision (sec. 216(b)(3)(A) of the 1984 Act), if a reinsurer's taxable year is not a calendar year, the first day of the first taxable year beginning after 1983 is the closing date of the period. This provision is intended to prevent abuse of the fresh-start provisions by use of reinsurance transactions after 1983 where the reinsurer's taxable year may be a fiscal year rather than the calendar year.

The Act clarifies that the change in the insurance company's reserves attributable to the "fresh start" will be taken into account in computing the current and accumulated earnings and profits of the insurance company. This adjustment to an insurance company's earnings and profits generally will be made as of the beginning of the first taxable year beginning after December 31, 1983.

An exception to the general rule relating to the adjustment to earnings and profits is provided in the case of certain insurance companies. In these situations, the adjustment to the insurance company's earnings and profits will be made as of the beginning of the company's first taxable year beginning after December 31, 1984.

Congress intended that the adjustment to earnings and profits is to be taken into account by the taxpayer for whom the fresh-start adjustment is relevant. For example, if a life insurance subsidiary was sold by a controlled group in 1984, the adjustment to earnings and profits should be taken into account with respect to the subsidiary before the sale of the subsidiary because the amount of the fresh-start adjustment is essentially determined as of the beginning of the first taxable year beginning after December 31, 1983. Thus, the seller, rather than the purchaser, would benefit by the adjustment to earnings and profits.

20. Treatment of certain elections under sec. 818(c) (secs. 1822(b) and (f) of the Act and sec. 216(b)(4) of the 1984 Act)

Prior Law

The 1984 Act provided that, except in a limited situation, any election after September 27, 1983, under section 818(c) (as in effect prior to the 1984 Act) to revalue preliminary term reserves to net level reserves would not take effect. An election under such section

818(c) was allowed to take effect after September 27, 1983, if more than 95 percent of the reserves computed in accordance with such election were attributable to risks under life insurance contracts issued by the taxpayer under a plan of insurance first filed after March 1, 1982, and before September 28, 1983.

The legislative history describing the denial of fresh start provisions described reserve strengthening as also including generally an election under section 818(c) (as in effect prior to the 1984 Act) which was made after September 27, 1983.

Explanation of Provision

The Act clarifies that a valid election under section 818(c) (as in effect prior to the 1984 Act), made under the exception described above, is not to be treated as reserve strengthening for purposes of denying a fresh start and requiring that the amount be taken into income in the first taxable year beginning after December 31, 1983. This allows a taxpayer that qualifies for the limited exception for making such a section 818(c) election after September 27, 1983, to have the full benefit of that election.

In addition, the Act provides a limited exception to the rule requiring section 818(c) elections to have been made on or before September 27, 1983. Under this exception, an election is treated as if it were made on or before September 27, 1983, if (1) before December 31, 1983, a qualified stock purchase (as defined in sec. 338(d)(3)) was made with respect to a life insurance company that had in effect a valid section 818(c) election before September 27, 1983, (2) an election under section 338 is made with respect to the company, and (3) a new section 818(c) election with respect to the new corporation (described in sec. 338(a)(2)) is made with respect to the corporation's taxable year beginning on the date of acquisition. The Act also extends the time for making the section 338 election with respect to such qualified stock purchase, and extends the time for making such an 818(c) election for the first taxable year of the life insurance company beginning in 1983 and ending after September 28, 1983. The time for making these elections expires on December 21, 1986.

Further, the Act provides that the statute of limitations for assessing any deficiency attributable such elections, or for filing a claim for credit or refund attributable to such elections, does not expire before October 22, 1988. Congress intended that no inference is to be drawn with respect to the treatment of an election under section 338 to increase the basis of any assets acquired by the amount of reserve liabilities assumed in connection with the acquisition.

21. Election not to have reserves recomputed (sec. 1822(c) of the Act and sec. 216(c) of the 1984 Act)

Prior Law

Under the 1984 Act, certain qualified life insurance companies can elect not to recompute reserves for existing contracts as of January 1, 1984, but rather to use their statutory reserves for all such contracts. In so using statutory reserves for tax purposes, a company elects to forego the "fresh start" with respect to the difference between statutory reserves and the Federally prescribed reserves; there is still a "fresh start" with respect to the difference between statutory reserves and prior law tax reserves attributable to a prior law 818(c) election.

Also, as a transitional rule under the 1984 Act, any company that makes the above described election and that has tentative LICTI for its first taxable year after 1984 of $3 million or less may further elect to have the reserve for any contract issued on or after 1983 and before January 1, 1989, be equal to the statutory reserve for the contract computed for tax purposes with an adjustment similar to the geometric Menge formula under TEFRA (sec. 805(c)(1) of prior law as in effect for 1982 and 1983).

These elections are to be made at the time and in the manner prescribed by the Secretary of the Treasury and, once made, are irrevocable.

Explanation of Provision

The Act makes it clear that, in determining whether a company is eligible to make the election for contracts issued on or after 1983 and before January 1, 1989, a company must compute its tentative LICTI taking into account reserves as though the election was in effect. The Act also clarifies that the so-called geometric Menge adjustment should be applied to opening and closing statutory reserves for purposes of computing net increases or decreases in life insurance reserves.

In addition, the Act provides that the reserve for a company making the election will be the greater of the company's statutory reserve (as adjusted by the geometric Menge adjustment) or the net surrender value of the contract.

22. Special rule for companies using net level reserve method for noncancellable accident and health insurance contracts (sec. 1823(a) of the Act and sec. 217(n) of the Act)

Prior Law

Under prior law, a company was treated as meeting the requirements of the Federally prescribed reserve method with respect to any noncancellable accident and health insurance contract for any taxable year if such company (1) used the net level reserve method to compute its tax reserves on such contracts for such taxable year, (2) was using the net level reserve method to compute its statutory reserves on such contracts as of December 31, 1982, and (3) has continuously used such method for computing such reserves on such contracts after December 31, 1982, and through such taxable year.

In explaining this special rule, the legislative history of the 1984 Act stated that a company can use the net level reserve method for tax purposes for noncancellable accident and health contracts sold under a particular plan of insurance, if the company computed all its reserves for such contracts on that method for statutory purposes as of December 31, 1982, (as evidenced by its 1982 annual statement, as originally filed) and continues to do so for all such reserves on both new and existing business.[3] If the company was not using a net level reserve method as of the prescribed date, with respect to contracts sold under a particular plan of insurance, the company must use the generally prescribed reserve method (2-year full preliminary term method) for all contracts under the plan. Likewise, the generally prescribed method must be used for noncancellable accident and health insurance contracts sold under any new plans of insurance.

The legislative history limited the application of the rule to noncancellable accident and health contracts sold under currently marketed plans of insurance, but not under new plans of insurance. The practical consequences of this limiting language was that no company, even one meeting the otherwise strict qualification requirements, will elect to use the special rule because the detriment of forgoing the fresh start (because noncancellable accident and health reserves are not revalued) will not be offset by any favorable future reserve treatment for new product developments.

Explanation of Provision

The special rule applicable to the use of the net level reserve method for noncancellable accident and health reserves was intended to be narrow in its application by requiring a complete and continuous commitment by the company to the use of the more conservative net level reserve method for its directly written noncancellable accident and health contracts as a reflection of the company's conservative business practices before a company could recognize such practices for tax purposes. Specifically, it was intended to address the factual situation of a company that has been predominantly a writer of noncancellable accident and health insurance and that had followed, and continues to follow, the business practice of computing all its reserves for directly written noncancellable accident and health contracts on a net level basis for State purposes. It was intended to allow such company to use this more conservative reserve basis for tax purposes.

Because the rule under prior law was impractically narrow, and would not result in any taxpayer making the election, the Act expands the coverage of the rule to allow the net level reserve method for tax purposes on any directly written noncancellable accident and health insurance contract, whether under existing or new plans of insurance. For purposes of applying this special rule and qualifying therefor, only reserves on directly written contracts will be taken into account because, as a reinsurer, a company would generally adopt the reserve method used by the ceding company. This limited expansion will allow the special rule to have its intended practical effect.

Although prior law required that all reserves for noncancellable accident and health insurance contracts be computed on a net level basis for statutory purposes as of December 31, 1982, the Act adopts a de minimis margin for error for purposes of administrative convenience. Accordingly, in order to qualify for the application of this rule, a company must have been using the net level reserve method to compute at least 99 percent of its statutory reserves for directly written noncancellable accident and health insurance contracts as of December 31, 1982, and for the 1982 calendar year must have received more than half its premium income from directly written noncancellable accident and health insurance.

[3] The Statement of Managers for the 1984 Act erroneously refers to 1983 in describing this part of the provision.

After December 31, 1983, the company will be treated as using the prescribed reserve method for a taxable year if through such taxable year, the company has continuously used the net level method for computing at least 99 percent of its tax and statutory reserves on its directly written noncancellable accident and health contracts. This requires a complete and continuous use of the net level method for tax and statutory purposes for all but one percent of directly written noncancellable accident and health contracts; for contracts for which the company does not use the net level method, the company should use the method used for statutory purposes, for purposes of computing tax reserves.

23. Underpayments of estimated tax (sec. 1824 of the Act and sec. 218 of the 1984 Act)

Prior Law

Under prior law, no addition to tax was made under the provision relating to failure by a corporation to pay estimated tax with respect to any underpayment of an installment required to be paid before July 18, 1984, to the extent that such underpayment was created or increased by any provision of the insurance tax subtitle and such underpayment is paid in full on or before the last date prescribed for payment of the first installment of estimated tax required to be paid after July 18, 1984.

Explanation of Provision

The Act repeals section 218 of the 1984 Act in favor of the application of the broader general relief granted by the Act under which no addition to tax shall be made for underpayments of estimated tax by corporations for any period before March 16, 1985 (by individuals, for any period before April 16, 1985), to the extent that such underpayment was created or increased by a provision of the 1984 Act.

24. Definition of life insurance contract; computational rules (sec. 1825(a) of the Act and sec. 7702(e)(1) of the Code)

Prior Law

Under prior and present law, a life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either (1) a cash value accumulation test, or (2) a test consisting of a guideline premium limitation requirement and a cash value corridor requirement. Under both tests, prior and present law prescribe minimum interest assumptions and mortality assumptions that must be taken into account in computing the limitations.

Under the cash value accumulation test, the cash surrender value of the contract, by the terms of the contract, may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured.

Under the guideline premium limitation/cash value corridor test, a contract continues to be treated as life insurance so long as it does not violate its guideline premium limitation or the cash value corridor. A life insurance contract meets the guideline premium limitation if the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date.

In addition, prior and present law provide three general rules or assumptions to be applied in computing the limitations set forth in the definitional tests. These computational rules restrict the actual provisions and benefits that can be offered in a life insurance contract only to the extent that they restrict the allowable cash surrender value (under the cash value accumulation tests) or the allowable funding pattern (under the guideline premium limitation). First, in computing the net single premium (under the cash value accumulation test) or the guideline premium limitation for any contract, the death benefit generally is deemed not to increase at any time during the life of the contract (qualified additional benefits are treated the same way). It is unclear under prior law whether this computational rule applies for purposes of determining the satisfaction of the cash value corridor test.

Second, the maturity date, including the date on which any endowment benefit is payable, shall be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100. Third, the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date described in the second computational rule) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

Under prior law, the term "premiums paid" meant the premiums paid under the contract minus amounts to which section 72(e) applies (other than amounts includible in income) and any other amounts specified in regulations.

Explanation of Provision

The Act clarifies the second computational rule by specifically stating that the maturity date shall be deemed to be no earlier than age 95 and no later than age 100.

The Act also adds an additional computational rule which provides that for purposes of applying the second computational rule and for purposes of determining the cash surrender value on the maturity date under the third computational rule, the death benefits shall be deemed to be provided until the maturity date described in the second computational rule. This rule combined with the second computational rule will generally prevent contracts endowing at face value before age 95 from qualifying as life insurance. However, it will allow an endowment benefit at ages before 95 for amounts less than face value.

Finally, the Act amends the computational rules to clarify that these rules do not apply for purposes of determining qualification under the cash value corridor test.

25. Treatment of policies to cover prearranged funeral expenses (sec. 1825(a)(4) of the Act and sec. 7702(e)(2) of the Code)

Prior Law

A life insurance contract generally is defined as a contract which meets either (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Future increases in death benefits may cause a contract not to qualify under these tests.

Explanation of Provision

The Act amends the definition of a life insurance contract to provide that future increases in death benefits may be taken into account in determining whether the definition of a life insurance contract is satisfied with respect to certain policies to cover payment of burial expenses or in connection with prearranged funeral expenses. Such contracts can qualify as a life insurance contract provided that (1) the initial death benefit under the contract is $5,000 or less (treating all contracts issued to the same contract owner as one contract), (2) the contract provides for fixed annual increases in the death benefit not exceeding 10 percent of the initial death benefit or 8 percent of the death benefit at the end of the preceding year, and (3) the death benefit under the contract (treating all contracts issued to the same owner as one contract) does not exceed $25,000.

Effective Date

The provision is effective on the date of enactment of the 1986 Act (October 22, 1986).[4]

26. Reduction in future benefits (sec. 1825(b) of the Act and sec. 7702(f)(7) of the Code)

Present Law

Under prior and present law, proper adjustments must be made for any change in the future benefits or any qualified additional benefit (or any other terms) under a life insurance contract, which was not reflected in any previous determination made under the definitional section. Changes in the future benefits or terms of the contract can occur by an action of the company or the policyholder or by the passage of time. However, proper adjustments may be made for a particular change, depending on which alternative test is being used or whether the changes result in an increase or decrease of future benefits.

[4] A technical correction may be needed so the statute reflects this intent.

In the event of an increase in current or future benefits, the limitations under the cash value accumulation test must be computed by treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the prescribed definition. Thus, if a future benefit is increased because of a scheduled change in death benefit or because of the purchase of a paid-up addition (or its equivalent) the change will require an adjustment in the new computation of the net single premium definitional limitation. Under the guideline premium limitation, an adjustment is required under similar circumstances, but the date of change for increased benefits should be treated as a new date of issue only with respect to the changed portion of the contract. Likewise, no adjustment shall be made if the change occurs automatically, for example, a change due to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or changes initiated by the company. If the contract fails to meet the limitations after proper adjustments have been made, a distribution of cash to the policyholder may be required in order to maintain qualification of the contract as life insurance.

Under prior law, the Secretary of the Treasury had the authority to prescribe regulations governing how such adjustments in computations of the definitional limitations were to be made. Such regulations could revise, prospectively, some of the adjustment rules described above in order to give full effect to the intent of the definitional limitations.

Further, under prior and present law, for the purpose of the adjustment rules, any change in the terms of a contract that reduces the future benefits under the contract will be treated as an exchange of contracts (under sec. 1035). Thus, any distribution required under the adjustment rules will be treated as taxable to the policyholder under the generally applicable rules of section 1035. This provision was intended to apply specifically to situations in which a policyholder changes from a future benefits pattern taken into account under the computational provision for policies with limited increases in death benefits to a future benefit of a level amount (even if at the time of change the amount of death benefit is not reduced). If the adjustment provision results in a distribution to a policyholder in order to meet the adjusted guidelines, the distribution will be taxable to the policyholder as ordinary income to the extent there is income in the contract.

The provision that certain changes in future benefits be treated as exchanges was not intended to alter the application of the transition rules for life insurance contracts and only applies with respect to such changes in contracts issued after December 31, 1984. Likewise, this adjustment provision was not intended to repeal indirectly the application of section 72(e) to life insurance contracts.

Explanation of Provision

In general.—The Act modifies the provision of prior law that governs how adjustments of future benefits will be treated under section 7702. The Act retains the requirement that, in determining whether the contract continues to qualify as life insurance, proper

adjustments be made when future benefits are changed. However, the express delegation of authority to the Secretary of the Treasury to issue regulations governing adjustments has been deleted. In its place, the Act contains specific rules governing the extent to which a reduction in future benefits will cause income to be recognized to the policyholder.

Specifically, the Act provides that if there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under the definitional section, there shall be proper adjustments in future determinations made under the definitional section. If the change reduces benefits under the contract, the adjustments may include a required distribution in an amount determined under the adjustment regulations for purposes of enabling the contract to meet the applicable definitional test. A portion of the distribution required by application of the definitional tests will be taxed as ordinary income to the extent there is income in the contract.

In stating the "income characterization" portion of the adjustment provision, the Act refers directly to the provisions governing the taxation of distributions from annuity and life insurance contracts, pointing out that the provision which allows withdrawals from life insurance contracts to be treated as withdrawal of investment first does not apply under certain circumstances.

Under the Act, a portion of the cash distributed to a policyholder as a result of a change in future benefits will be treated as being paid first out of income in the contract, rather than as a return of the policyholder's investment in the contract, only if the reduction in future benefits occurs during the 15-year period following the issue date of the contract.

Congress intended that, if a contract originally issued before December 31, 1984, is changed after that date in such a manner or extent that it is treated as newly issued after December 31, 1984, then the 15-year period is to commence on the date (after December 31, 1984) on which the contract is considered as newly issued. If the 15-year period were considered to commence when the contract was originally issued, then contracts issued before 1985 could become vehicles for circumvention of the distribution rules described below, regardless of how substantially such contracts were changed after 1984.

Changes during first 5 years.—For the first 5 years following the issuance of the contract, the amount that will be treated as having been paid first out of income in the contract will be equal to the amount of the required distribution under subparagraph (A) of section 7702(f)(7). This amount will depend on whether the contract meets the cash value accumulation test or the guideline premium/cash value corridor test of section 7702(a). In the case of a contract to which the cash value accumulation test applies, the excess of the cash surrender value of the contract over the net single premium determined immediately after the reduction shall be required to be distributed to the policyholder. In the case of a contract to which the guideline premium/cash value corridor test applies, the amount of the required distribution is equal to the greater of (1) the excess of the aggregate premiums paid under the contract over the redetermined guideline premium limitation, or (2) the excess of the cash surrender value of the policy immediately before the reduction over the redetermined cash value corridor. The guideline premium limitation shall be redetermined by using an "attained-age-decrement" method.

Under this method, when benefits under the contract are reduced, the guideline level and single premium limitations are each adjusted and redetermined by subtracting from the original guideline premium limitation a "negative guideline premium limitation" which is determined as of the date of the reduction in benefits and at the attained age of the insured on such date. The negative guideline premium limitation is the guideline premium limitation for an insurance contract that, when combined with the original insurance contract after the reduction in benefits, produces an insurance contract with the same benefit as the original contract before such reduction.

To the extent that the redetermined guideline premium limitation requires a distribution from the contract, the amount of the distribution will also be an adjustment to premiums paid under the contract (within the meaning of sec. 7702(f)(1)(A), to be specified in regulations). It is understood that any adjustments to premiums paid as part of the definitional determinations will be independent of, and may differ in amount from, the determination of investment in the contract for purposes of computing the amount of income in the contract (under sec. 72).

Changes during years 6 to 15.—For cash distributions occurring between the end of the fifth year and the end of the fifteenth year from the issuance date of the policy, a single rule applies for all contracts. Under this rule, the maximum amount that will be treated as paid first out of income in the contract will equal the amount by which the cash surrender value of the contract (determined immediately before the reduction in benefits) exceeds the maximum cash surrender value that would not violate the cash value corridor (determined immediately after the reduction in benefits).

Distribution in anticipation of a reduction.—The Act also provides that certain distributions of cash made in anticipation of a reduction in benefits under the contract shall be treated as a cash distribution made to the policyholder as a result of such change in order to give full effect to the provision. Any distribution made up to two years before a reduction in benefits occurs will be treated as having been made in anticipation of such a reduction. The Secretary of the Treasury is authorized to issue regulations specifying other instances when a distribution is in anticipation of a reduction of future benefits. In addition, the regulations may specify the extent to which the rules governing the calculation of the maximum amount that will be treated as paid first out of income in the contract will be adjusted to take account of the prior distributions made in anticipation of reduction of benefits.

Definition of premiums paid.—The Act modifies the definition of the term "premiums paid." Under the Act, premiums paid are computed in the same manner as under prior law, except that the premiums actually paid under the contract will be further reduced by amounts treated as paid first out of income in the contract under the revised adjustment rule. This reduction in premiums

paid is limited to the amounts that are included in gross income of the policyholder solely by reason of the fact that a reduction in benefits has been made.

27. Treatment of contracts that do not qualify as life insurance contracts (sec. 1825(c) of the Act and sec. 7702(g) of the Code)

Prior Law

If a life insurance contract does not meet either of the alternative tests under the definition of a life insurance contract, the income on the contract for the taxable year of the policyholder will be treated as ordinary income received or accrued by the policyholder during that year. For this purpose, the income on the contract is the amount by which the sum of the increase in the net surrender value of the contract during the taxable year and the cost of insurance protection provided during the taxable year exceed the amount of premiums paid less any policyholder dividends paid under the contract during the taxable year. The term premiums paid means the amount paid as premiums under a contract less amounts to which the rules for allocation between income and investment under annuity and other contracts in section 72(e) apply.

Explanation of Provision

Under the Act, income in the contract is computed without reduction by the amount of policyholder dividends paid under the contract during the taxable year. This change was necessary to avoid overstating the income in the contract, which otherwise would occur due to the fact that policyholder dividends are treated as a nontaxable return of basis under section 72(e) and reduce premiums paid directly. If these dividends were also added to the amount of income on the contract, income would be overstated because policyholder dividends would reduce premiums paid twice.

28. Treatment of flexible premium contracts issued during 1984 which meet new requirements (sec. 1825(d) of the Act and sec. 221(d)(1) of the 1984 Act)

Present Law

Under the 1984 Act, the new definition of life insurance generally applies to contracts issued after December 31, 1984, except in the case of certain increasing death benefit contracts issued after June 30, 1984. Also, the TEFRA provisions for flexible premium contracts (that is, prior-law sec. 101(f) applicable during 1982 and 1983) were extended through 1984.

Explanation of Provision

The Act clarifies the transition rules for the definition of life insurance so that any contract issued during 1984 which meets the definitional requirements of section 7702 will be treated as meeting the requirements of prior-law section 101(f), which was extended through 1984.

29. Treatment of certain contracts issued before October 1, 1984 (sec. 1825(e) of the Act and sec. 221(d)(2)(C) of the 1984 Act)

Prior Law

Under the 1984 Act, a transition rule was provided for certain increasing death benefit policies. This rule made the new definitional provisions of section 7702 applicable only for a contract issued after September 30, 1984, if (1) the contract would meet the new definition by substituting 3 percent for 4 percent as the minimum interest rate in the cash value accumulation test (assuming that the rate or rates guaranteed on issuance of a contract can be determined without regard to any mortality charges), and (2) if the cash surrender value of the contract did not at any time exceed the net single premium which would have to be paid at such time to fund future benefits at the then current level of benefits (with the same 3 percent for 4 percent substitution).

Explanation of Provision

The Act clarifies the transition rule so that, in applying the cash value accumulation test by substituting 3 percent for 4 percent as the minimum interest rate, the taxpayer should not only assume that the rate or rates guaranteed on issuance of the contract can be determined without regard to any mortality charges, but should also assume that the rate or rates should be determined without regard to any initial interest rate guaranteed in excess of the stated minimum rate.

30. Amendments related to annuity contracts (sec. 1826 of the Act and sec. 72(q) and (s) of the Code)

Prior Law

Under prior and present law, cash withdrawals from an annuity contract prior to the annuity starting date are includible in gross income to the extent that the cash value of a contract (determined immediately before the amount was received and without regard to any surrender charge) exceeds the investment in the contract. An additional income tax of 5 percent was imposed, under prior law, on the amount of any such distribution that was includible in income, to the extent that the amount was allocable to an investment made on or after August 14, 1982. This tax was not imposed if the distribution was made after the contractholder attained age 59½, after the contractholder became disabled, upon the death of the contractholder, or as payment under an annuity for life or for at least 5 years.

An annuity contract must provide specific rules for distribution in the event of the contractholder's (owner's) death in order to be treated as an annuity contract for income tax purposes under prior and present law. These after-death distribution rules generally conform to those rules applicable to qualified pension plans and IRAs. To be treated as an annuity contract, the contract must provide that, if the contractholder dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distribution in effect before death. If the contractholder dies before the annuity starting date, the entire interest generally must be distributed within 5 years after the date of death of the contractholder, or must be annuitized for some period (including the life of a designated beneficiary) within one year after the date of death. For these purposes, the beneficiary is the person who becomes the new owner of the annuity contract and controls the use of the cash value of the contract.

If there is a spousal beneficiary, the contract (including deferral of income tax) may be continued in the name of the spouse as the contractholder upon the contractholder's death. Thus, a spousal beneficiary steps into the shoes of the decedent contractholder.

To the extent that the terms used refer to individuals (e.g., death, spouse, or age), the provisions apply only to individual contractholders (owners) of annuity contracts. A person who holds legal title to an annuity contract in a representative capacity, such as a custodian or trustee, is not treated as the contractholder. Rather, the beneficial owner of the contract is the holder.

Explanation of Provision

The Act provides an exception to the requirement that the annuity contract include required distribution provisions in order to be treated as an annuity in the case of annuity contracts which are used as part of a qualified pension plan or for an IRA by adopting a specific statutory exemption for these purposes. This provision is added because annuity contracts provided under a qualified pension plan or an IRA must satisfy the required distribution rules applicable to such plans and should not be required to satisfy an essentially duplicative set of rules applicable to annuity contracts.

In addition, the Act includes special rules to clarify the application of the required distribution rules if the contractholder is not an individual, which provide that the primary annuitant shall be treated as the holder of the contract. For these purposes, the term "primary annuitant" means the individual, the events in the life of whom are of primary importance in affecting the timing or amount of the pay-out under the contract. For example, the primary annuitant would be that person referred to in the contract as the measuring life for the annuity starting date or for annuity benefits payable under the contract.

Likewise, the Act clarifies the application of the exception to the additional income tax for distributions at death so that the tax does not apply to any distribution made on or after the death of the contractholder or, if the contractholder is not an individual, the death of the primary annuitant. Thus, the additional income tax on early withdrawals (sec. 72(q)) is not imposed on an after-death distribution required under section 72(s).

The Act also adds a provision which states that if an individual who holds an annuity contract transfers it by gift, then such transfer or change shall be treated as an assignment of the contract (sec. 72(e)(4)), which treats the amount assigned as received as an amount not received as an annuity. In general, the value of the contract assigned will equal the net surrender value of the contract, determined with regard to any policy loan. The investment in the contract of the grantee will be treated as equal to the investment in the contract of the grantor plus the amount included in the gross income of the grantor.

On the other hand, in the case of a holder which is not an individual, if there is any change in the primary annuitant, then the change is treated as the death of the holder and the required distribution rules apply.

Without these clarifications relating to gratuitous transfers of annuity contracts and changes in primary annuitants, the required distribution rules adopted in the 1984 Act could be avoided easily because they would allow taxpayers to continue tax deferral beyond the life of an individual taxpayer. There is an exception to the rule for transfers of annuity contracts by gift where the transfer is made to a spouse. Specifically, the contract will not be treated as assigned with respect to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.

In addition, the Act addresses the issue of how joint contractholders should be treated when one holder dies and clarifies that the after-death distribution requirements apply upon the death of any holder of such contract.

In order to allow annuity writers time to make changes conforming to the clarifications contained in this Act, these provisions shall apply to contracts issued after April 22, 1987.

Finally, the Act provides that any annuity used as a qualified funding asset in a structured settlement will not be subject to the additional income tax imposed on the portion of any premature distribution from an annuity contract that is included in gross income.

31. Amendments related to group-term insurance (sec. 1827 of the Act and secs. 79 and 83(e) of the Code)

Prior Law

Under prior and present law, the cost of group-term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost of $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. The $50,000 cap on the group-term life insurance exclusion is applicable to active employees and to former employees other than employees who have terminated employment because of disability. Generally, the cost of group-term life insurance is determined on the basis of uniform premiums, computed with respect to 5-year age brackets, under a table prescribed by the Secretary of the Treasury.

Under prior law, if a group-term life insurance plan maintained by an employer discriminated in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance was further limited. In the case of a discriminatory plan, the full cost of the group-term life insurance for any key employee was included in the gross income of the employee at actual cost, rather than the table cost.

The 1984 Act amendments relating to group-term life insurance were effective for taxable years beginning after December 31, 1983. The provisions did not apply with respect to certain grandfathered individuals who receive group-term life insurance under a plan in existence on January 1, 1984 (or under a comparable successor plan).

Explanation of Provision

The Act provides that, in the case of a discriminatory group-term life insurance plan, the cost of group-term life insurance on the life of any key employee shall be the greater of the actual cost of the insurance or the cost determined based on the uniform premium table.

In addition, the Act revises the definition of key employee to include any former employee if such employee, at the time of separation from service, was a key employee. An employee is a key employee at separation from service if the employee was a key employee for the year in which separation occurs or for any of the 4 preceding years. For purposes of applying the nondiscrimination requirements of the group-term life insurance provisions, the Act also clarifies that, to the extent provided in regulations, coverage and benefit tests are applied separately to active and former employees.

The Act also makes a clerical correction to section 83(e)(5), which coordinates that section with section 79. Section 83(e)(5) presently excepts the cost of group-term life insurance to which section 79 applies from the application of section 83 (governing the taxation of property transferred in connection with the performance of services). The Act provides that section 83 shall not apply to group-term life insurance covered by section 79. Thus, when an employee retires, the present value of any future group-term life insurance coverage which may become nonforfeitable upon retirement (or the value of an amount set aside by an employer to fund such coverage) will not be taxed immediately to the employee upon retirement. Rather, if the coverage constitutes group-term life insurance within the meaning of section 79 (e.g., the employee does not receive a permanent guarantee of life insurance coverage from the insurance company), the cost of the coverage will be taxable annually to the retired employee under section 79. This rule also applies in the case of an employee who separates from service with a vested right to continuing group-term life insurance coverage.

Further, the Act clarifies the effective date of the provisions adopted in the 1984 Act by providing that the extension of the $50,000 cap to retired employees and the extension of the nondiscrimination provisions to former employees do not apply to any group-term life insurance plan of the employer in existence on January 1, 1984, but only with respect to an individual who attained age 55 on or before January 1, 1984, and was employed by such employer (or a predecessor employer) at any time during 1983. The 1984 Act amendments also shall not apply to any employee who retired from employment on or before January 1, 1984, and who, when he retired, was covered by a group-term life insurance plan of the employer (or a predecessor plan).

The Act amends the rules with respect to grandfathered individuals to provide that, in applying the nondiscrimination rules under section 79, such individuals may be disregarded at the employer's election.

The provision relating to the determination of costs with respect to key employees in a discriminatory plan is effective for taxable years ending after the date of enactment of the Act.

The Act clarifies what qualifies as a comparable successor plan for purposes of the grandfather provision under the 1984 Act. A comparable successor plan includes, with respect to a grandfathered individual, any plan that does not provide increased benefits. If the benefits of a grandfathered individual are increased, the grandfather rule no longer applies to that individual. The grandfather rule treatment is, however, retained with respect to any employee whose benefits do not increase under the plan.

For purposes of determining whether the benefits of an employee increase, it is anticipated that rules similar to those of section 79(c) and Treasury Regulation section 1.79-3 are to apply, but amounts excluded from gross income under section 79(a)(1) are taken into account.

If the employee's share of the total cost of group-term life insurance decreases, then such a decrease is treated as increased benefits under the plan, thereby eliminating the grandfather treatment for the employee. Whether the employee's share of the cost of group-term life insurance decreases is determined by the change in the employee's share per $1,000 of insurance coverage.

32. Amendment related to certain exchanges of insurance policies (sec. 1828 of the Act and sec. 1035(b) of the Code)

Prior Law

Under prior and present law, no gain or loss is recognized on the exchange of (1) a contract of life insurance for another contract of life insurance or for an endowment or an annuity contract; (2) a contract of endowment insurance for another contract of endowment with the same or earlier payment date, or for an annuity contract; or (3) an annuity contract for an annuity contract. For purposes of this exchange rule, an endowment contract and a life insurance contract are defined to include contracts issued by any insurance company taxable under subchapter L of the Code. This change in law effective in 1984 was intended to recognize that the focus of the exchange rule should be on the character and benefits of the contract rather than the particular tax status of the company issuing the contract.

Explanation of Provision

The Act amends the definition of an endowment contract and a life insurance contract by merely requiring that the contracts be issued by any insurance company, whether or not such company is a taxable entity under the Code. This provision applies to exchanges occurring before, on, or after October 22, 1986.

33. Waiver of interest on certain underpayments of tax (sec. 1829 of the 1984 Act)

Prior Law

Under prior and present law, interest on an underpayment of tax generally is payable from the due date of the return (determined without regard to extensions).

Explanation of Provision

The Act provides that no interest shall be payable for any period before July 19, 1984, on any underpayment of tax imposed by the Internal Revenue Code, to the extent such underpayment was created or increased by any provision of subtitle A of title II of the Tax Reform Act of 1984.

34. Scope of section 255 of the Tax Equity and Fiscal Responsibility Act of 1982 (sec. 1830 of the Act)

Prior Law

Section 255 of the Tax Equity and Fiscal Responsibility Act of 1982 repealed section 820 of the Code relating to the option treatment of modified coinsurance contracts and adopted a grandfather provision with respect to the treatment of modified coinsurance contracts for taxable years prior to 1982. Under this grandfather rule, any determination as to whether any contract met the requirements of section 820 (before repeal) (1) was to be made solely by reference to the terms of the contract, and (2) the treatment of the contract was made in accordance with the regulations under section 820 as in effect on December 31, 1981. Under TEFRA, such contracts were grandfathered except in the event of fraud.

The Internal Revenue Service has recently issued "guidelines" to auditing agents instructing them to raise certain issues with respect to modified coinsurance contracts. The guidelines apply to taxable years prior to 1982 and direct agents to examine two issues: (1) the date on which modified coinsurance contracts became effective, and (2) the rate at which investment income was transferred under the contracts.

Explanation of Provision

The provision clarifies the intent of Congress that, for taxable years prior to January 1, 1982, the IRS should give full and complete effect to the terms of a modified coinsurance contract. Accordingly, under the provision, the IRS is to respect the manner in which the terms of a modified coinsurance contract have been reflected on the tax return. In particular, the provision requires the IRS to recognize the investment income rate terms and the effective date terms stated in the contract.

C. Technical Corrections to Private Foundation Provisions

1. Reduction in section 4940 excise tax where charitable payout meets certain distribution requirements (sec. 1832 of the Act and sec. 4940 of the Code)

Prior Law

Under the 1984 Act, the rate of the excise tax imposed on the net investment income of a private foundation (Code sec. 4940) is reduced for a taxable year from two percent to one percent if the amount of qualifying distributions made by the foundation during that taxable year equals or exceeds the sum of (1) an amount equal to the foundation's assets for such taxable year multiplied by the average percentage payout for the base period, plus (2) one percent of the foundation's net investment income for such taxable year. However, the reduction is not available for a year if the foundation's average percentage payout for the base period is less than five percent, or 3⅓ percent in the case of a private operating foundation (sec. 4940(e)(2)(B)). The reduction in the section 4940 tax rate is effective for taxable years beginning after 1984.

Explanation of Provision

The Act modifies the rule disqualifying certain foundations from the section 4940 rate reduction, to provide that the rate reduction is not available if the foundation was liable for tax under section 4942 with respect to any year in the base period.

This modification effectuates the intended rule that a foundation which failed in any base period year to make the minimum required expenditures for charitable purposes should not be eligible to obtain the benefit of tax reduction merely by increasing its qualifying distributions (in an amount at least equal to one percent of net investment income) up to the minimum section 4942 level. As a result of the modification made by the Act, a nonoperating foundation will not be disqualified from the rate reduction in two situations where the foundation does not incur liability for section 4942 taxes even though the amount of its qualifying distributions (sec. 4942(g)) does not equal at least five percent of its assets. The first situation results from the fact that under section 4942(d), the distributable amount equals the minimum investment return (five percent of assets) reduced by the sum of any taxes imposed on the foundation for the taxable year under section 4940 and the unrelated business income tax. The second situation results from the fact that under section 4942(i), the distributable amount is further reduced by the amount of any excess distributions carryovers from a prior year. However, since neither the amount of such taxes nor the amount of such carryover distributions is included in the definition of qualifying distributions in section 4942(g), a foundation

whose distributable amount is reduced by such taxes or carryover excess distributions does not incur section 4942 tax liability if the amount of its qualifying distributions, while less than the minimum investment return, equals or exceeds the distributable amount as thus computed. At the same time, the technical amendment made by the Act precludes any reduction in the section 4940 tax if, with respect to any base period year, the foundation is liable for tax under section 4942 for failure to satisfy the minimum distribution requirements.

2. Exemption for certain games of chance (sec. 1833 of the Act and sec. 513 of the Code)

Prior Law

The 1984 Act provides that, for purposes of Code section 513, the term unrelated trade or business does not include any trade or business that consists of conducting a game of chance if (1) the game of chance is conducted by a nonprofit organization, (2) the conducting of the game by such organization does not violate any State or local law, and (3) as of October 5, 1983, there was a State law in effect that permitted the conducting of the game of chance only by a nonprofit organization (i.e., the conducting of the game of chance by other than nonprofit organizations would violate the State law). This provision applies to games of chance conducted after June 30, 1981.

Explanation of Provision

The Act clarifies that the only State law to which the provision is intended to apply is a North Dakota law originally enacted on April 22, 1977.

D. Technical Corrections to Tax Simplification Provisions

1. Domestic relations provisions (secs. 1842 and 1843 of the Act and secs. 71 and 1041 of the Code)

Prior Law

The 1984 Act revised the rules defining deductible alimony and generally provided that property transfers between spouses or incident to divorce were tax-free.

Explanation of Provisions

Alimony

The Act makes several changes to the alimony rules. First, the Act provides that alimony payments will not be disqualified solely because the decree does not specifically state that the payments will terminate at the payee's death.

The Act also revises the front-loading alimony rules of section 71(f) in order to better conform to the current trend of state divorce law to require short term support payments on a theory of "rehabilitative alimony". Under the Act, if the alimony payments in the first year exceed the average payments in the second and third year by more than $15,000, the excess amounts are recaptured in the third year by requiring the payor to include the excess in income and allowing the payee who previously included the alimony in income a deduction for that amount in computing adjusted gross income. A similar rule applies to the extent the payments in the second exceed the payments in the third year by more than $15,000. This rule is intended to prevent persons whose divorce occurs near the end of the year from making a deductible property settlement in the beginning of the next year. Unlike prior law, there is no requirement that payments be made over a minimum term. Recapture is not required if either party dies or if the payee spouse remarries by the end of the calendar year which is two years after the payments began and payments cease by reason of that event. Also the rule does not apply to temporary support payments (described in sec. 71(b)(2)(C))[1] or to payments which fluctuate as a result of a continuing liability to pay, for at least three years, a fixed portion or portions of income from the earnings of a business, property or services. The portions of the payor's income which are payable to the payee spouse under this exception may

[1] The principles set forth in Treas. Reg. sec. 1.71-1T(d) (A-22, last sentence) are intended to continue to apply to temporary support payments under the amended provision.

vary as the payor's income varies, so long as the percentages are themselves fixed in the instrument.

Thus, for example, if the payor makes alimony payments of $50,000 in the first year and no payments in the second or third year, $35,000 will be recaptured (assuming none of the exceptions apply). If instead the payments are $50,000 in the first year, $20,000 in the second year and nothing in the third year, the recapture amount will consist of $5,000 from the second year (the excess over $15,000) plus $27,500 for the first year (the excess of $50,000 over the sum of $15,000 plus $7,500). (The $7,500 is the average payments for years two and three after reducing the payments by the $5,000 recaptured from year two.)

This new provision will generally apply to divorce or support decrees and agreements executed after 1986. The provision will also apply with respect to the modification of a prior instrument where the modified instrument expressly so provides. The Act also reduces the recapture period to three years for those divorce decrees and agreements not covered by the amendment described above.

Property transfers

With respect to property transfers, the Act clarifies that in the case of the transfer of property to a trust for the assumption of (or subject to) liabilities in excess of basis, gain will be recognized to the extent of such excess notwithstanding section 1041(a).[2] Gain will also be recognized on the transfer of installment obligations to a trust. These rules are not intended to apply where any gain will be taxed to the transferor under the grantor trust rules.

2. Miscellaneous amendments (secs. 1841 and 1844–1848 of the Act)

Prior Law

The 1984 Act contained a title which added a number of provisions intended to simplify and improve the laws. These included provisions related to the individual estimated tax, at-risk, administrative provisions, distilled spirits, the Tax Court, income tax credits and deadwood.

Explanation of Provision

The Act makes numerous nonsubstantive clerical and conforming amendments to these provisions.

The Act also restores two provisions of prior law which were inadvertently changed by the 1984 Act. First, certain non-resident aliens will continue to be required to make estimated tax payments in three, rather than four, installments. One-half of the estimated tax will be due with the first payment. Second, the principles of

[2] In as much as this rule is similar to the rule involving certain corporate transfers under section 357(c), principles applicable under that section are intended to apply to section 1041(e).

pre-1984 law relating to the carryover of credits (including the foreign tax credit) by taxpayers subject to the alternative minimum tax are restored. The conforming amendment relating to the foreign tax credit will apply to taxable years beginning after December 31, 1982 (the effective date of the changes to the minimum tax made by TEFRA).[3]

[3] The alternative minimum tax was completely rewritten by Title VII of the Act, effective for taxable years beginning after 1986.

E. Technical Corrections to Employee Benefit Provisions

1. Funded Welfare Benefit Plans (sec. 1851 of the Act and secs. 419, 419A, 505, 512, and 4976 of the Code)

Under prior and present law, the amount of the deduction otherwise allowable to an employer for a contribution to a welfare benefit fund for any taxable year is not to exceed the qualified cost of the fund for the year. The qualified cost of a welfare benefit fund for a year is the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to reserves under the fund for the year (the qualified asset account), reduced by the after-tax income of the fund. The deduction limits do not apply to a 10-or-more employer plan.

a. Definition of fund

Prior Law

Under prior and present law, a fund is defined as any tax-exempt social club, voluntary employees' beneficiary association (VEBA), supplemental unemployment compensation benefit trust (SUB), or group legal services organization; any trust corporation, or other organization not exempt from income tax; and, to the extent provided by Treasury regulations, any account held for an employer by any person. A fund includes a retired life reserve account maintained by an insurance company on behalf of an employer. Under prior law, if an employer contributed amounts to an insurance company for benefits and under that arrangement the employer was entitled to a rebate if the amount paid exceeded benefit claims or was liable if the benefit claims exceeded the amount paid, then such contributions were considered to have been made to a welfare benefit fund.

Under prior and present law, an employer is not permitted a deduction for premiums paid on a life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the employer, if the employer is directly or indirectly a beneficiary of the policy (Code sec. 264(a)(1)).

Explanation of Provision

The Act amends the definition of a "fund" to exclude amounts held under the following types of insurance arrangements: (1) an insurance contract subject to sec. 264(a)(1); and (2) certain "qualified nonguaranteed contracts."

First, under the Act, the term "fund" does not include amounts held by an insurance company pursuant to a life insurance policy on the life of an officer, employee, or person financially interested in the trade or business of the employer, if the employer is the direct or indirect beneficiary of the policy because the amounts contributed are not deductible by the employer.

The Act also modifies the term "fund" to exclude amounts held by an insurance company under certain "qualified, nonguaranteed contracts." A qualified, nonguaranteed insurance contract is defined as an insurance contract (including a reasonable premium stabilization reserve) under which (1) there is not a guarantee of a renewal of the contract at guaranteed premium rates, and (2) other than current insurance protection, the only payments to which the employer or employees are entitled under the contract are refunds or policy dividends that are not guaranteed, that are experience rated, and that are determined by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer or their beneficiaries.

Thus, under the Act, amounts that are held by an insurance company for an employer generally are not to be treated as a fund to the extent that the amounts are subject to a significant current risk of economic loss that is determined, in part, by factors other than the amount of welfare benefits paid to (or on behalf of) the employees of the employer. Experience refunds or policy dividends are determined by additional factors if they reflect a charge for pooling of large individual claims, if the insurance company's retention reflects a risk charge related to the insurer's actual or anticipated experience under the class of business to which the contract belongs, or if the claims experience of other policyholders is otherwise taken into account. For example, an additional factor is present if the experience refund or policy dividend is based on the experience of a single employer together with a risk charge that is intended to assess the employer for an appropriate share of the insurance company's anticipated losses under policies if claims and expenses exceed premiums collected. Congress did not intend, however, that a de minimis risk charge on its own is sufficient to create a significant risk of economic loss.

Congress emphasized that, in prescribing regulations relating to the definition of a fund, the Treasury Department is to take into account that the principal purpose of the provision is to prevent employers from taking premature deductions for expenses that have not yet been incurred. To the extent that the temporary and proposed regulations could be interpreted to include in the definition of a fund certain experience-rated insurance arrangements with a significant current risk of economic loss, Congress did not believe that the regulations implemented this purpose. Congress believed that significant premature deductions do not occur with respect to experience-rated group insurance because of the element of insurance risk transferred to the insurance company. Thus, by excluding qualified nonguaranteed insurance contracts from the definition of a fund, the Act makes clear that typical group insurance arrangements are not to be made subject to the welfare benefit fund provisions through regulations. In addition, Congress reiterated that any regulations defining the term "fund" should take into account that the principal purpose of the provision is to prevent premature deductions by employers.

Congress intended that the definition of a qualified, nonguaranteed insurance contract include amounts held by an insurance company pursuant to certain guaranteed renewal contracts, under which the employer's right to renew the contract is guaranteed, but the level of premiums charged to the employer is not guaranteed. Congress believed that, if the insurance company can increase premiums charged to an employer to the point at which the contract is no longer feasible for the employer, the contract should not be treated as a guaranteed renewal contract.

In addition, the Act provides that even an arrangement that satisfies the definition of a qualified, nonguaranteed insurance contract will not be excluded from treatment as a fund, unless the amount of any experience rated refund or policy dividend payable with respect to a policy year is treated by the employer as paid or accrued in the taxable year in which the employer's contributions for the policy year were deductible. If the actual amount of the refund or dividend is not known by the due date of the employer's tax return for the year, Treasury regulations could permit the use of a reasonable estimate of the amount of such refund or dividend. In addition, Treasury regulations could require insurance companies to submit information (including proprietary information of the insurance company) relating to the basis for the calculation of experience refunds and policy dividends.

To the extent that the general rules for the exclusion of amounts held by an insurance company are satisfied, amounts held by an insurance company for a reasonable premium stabilization reserve for an employer are not treated as a fund. Thus, a premium stabilization reserve, if limited to a reasonable amount, is not treated as a fund to the extent that (1) such amounts are subject to a significant current risk of economic loss, and (2) experience rated refunds and policy dividends payable by the reserve with respect to a policy year are treated by the employer as paid or accrued in the taxable year in which the employer's contributions for such policy year were deductible. Solely for purposes of these provisions, the amounts released from a premium stabilization reserve to purchase current insurance coverage are to be treated as experience rated refunds or policy dividends.

Whether amounts are subject to a significant current risk of loss depends upon the facts and circumstances. For example, if an employer does not have a guaranteed right under an insurance contract to policy dividends based solely on the employer's experience but the insurance company has, in practice, consistently paid such dividends based solely on the employer's experience, it is anticipated that Treasury regulations would provide that the amounts held under the contract constitute a fund because they are not subject to a significant current risk of economic loss.

b. Coordination of post-retirement medical benefits with limits on contributions under qualified plans

Prior Law

Under the provisions of the 1984 Act relating to the coordination of net contributions for post-retirement medical benefits with the overall limits on contributions and benefits under qualified pension plans and certain other funded plans deferring compensation (secs. 415(c) and (e)), any amount allocated to a separate account for a key employee is treated as an annual addition to a defined contribution plan. Under the overall limits, the annual addition with respect to an employee under all defined contribution plans of an employer for a year is not to exceed the lesser of $30,000 or 25 percent of compensation. A lower limit may apply if the employer also maintains a defined benefit plan for the employee.

Under prior law, the 25-percent limit prevented reserve additions for post-retirement medical benefits after the retirement of a key employee. Thus, if an employer made additional contributions to a fund for post-retirement medical benefits on behalf of a retired key employee, then the contribution violated the 25 percent of compensation limit because a retired employee had no compensation.

Explanation of Provision

The Act provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the overall limits on qualified plans is not subject to the 25-percent-of-compensation limit usually applicable to annual additions. For example, assume the compensation of an employee is $100,000 for a year and $5,000 is treated as an annual addition under the limits for the employee under the rules for post-retirement medical benefits under a qualified plan. Assume further that the employee's annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit, is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the Act, the total annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition of $30,000 is, however, subject to the separate dollar limit of section 415(c) for the year and, if the employer also maintains a defined benefit plan for the employee, the full annual addition of $30,000 is taken into account in determining whether the combined plan limits of section 415(e) are satisfied.

The effect of this rule also is to permit the funding of post-retirement medical benefits on behalf of a key employee during periods when the employee has no compensation from the employer (e.g., after retirement).

c. Separate accounting required for certain amounts

Prior Law

In order to provide an overall limit with respect to pre-retirement deductions for certain post-retirement benefits of key employees, the 1984 Act required separate accounting for contributions to provide post-retirement medical or post-retirement life insurance benefits to an individual who is, or ever has been (after the effective date of the 1984 Act), a key employee.

Explanation of Provision

The Act clarifies the requirement for separate accounting with respect to post-retirement medical benefits and post-retirement life insurance benefits. Under the Act, the separate accounting requirement does not apply until the first taxable year for which a reserve is computed using the special provisions applicable to these benefits (or assets of a fund held before the effective date are allocated to a separate account). The separate account requirement applies for that first year and for all subsequent taxable years.

d. Reserves for discriminatory post-retirement benefits disregarded

Prior Law

Under the 1984 Act, no reserve is to be taken into account in computing the account limit with respect to a post-retirement medical benefit or a post-retirement life insurance benefit under a plan that does not meet the nondiscrimination standard provided by the 1984 Act (sec. 505). Under prior law, the application of this rule was unclear both with respect to benefits (such as benefits under a self-insured health plan) that were subject to nondiscrimination requirements different from the Act's standard and with respect to benefits (such as benefits under an insured plan) not subject to any nondiscrimination requirement. The nondiscrimination standards of the Act do not apply to benefits under certain collectively bargained plans.

Explanation of Provision

The Act provides that no reserve generally may be taken into account in determining the account limit for a welfare benefit fund for post-retirement medical benefits or life insurance benefits (including death benefits) unless the plan meets the nondiscrimination requirements with respect to those benefits (sec. 505(b)), whether or not those nondiscrimination requirements apply in determining the tax-exempt status of the fund. The bar against taking post-retirement medical benefits and life insurance benefits into account in determining the account limit does not apply, under the Act, in the case of benefits provided pursuant to a collective bargaining agreement between one or more employee representatives and one or more employers if the Secretary of the Treasury finds that the agreement is a collective bargaining agreement and that post-retirement medical benefits or post-retirement life insurance benefits (as the case may be) were the subject of good faith bargaining between the employee representatives and the employer or employers.

The Act clarifies that certain post-retirement group-term life insurance benefits that fail to satisfy the nondiscrimination requirements of Code section 505(b) may, nevertheless, be taken into account in determining the account limit to the extent that the group-term life insurance benefits are provided under an arrangement with respect to individuals grandfathered under section 223 of the 1984 Act.

e. Account limit for life insurance benefits

Prior Law

In the case of a life insurance or death benefit, the 1984 Act provided that the account limit is not to include a reserve to the extent the reserve takes account of an amount of insurance that exceeds the amount that may be provided to an employee tax-free under an employer's group-term life insurance program (sec. 79). In the case of a self-insured death benefit, the account limit is not to include a reserve to the extent that a benefit would be includible in gross income if the limit on excludable death benefits were $50,000.

Explanation of Provision

The Act clarifies that life insurance benefits are not to be taken into account in determining the account limit under a welfare benefit fund to the extent that the aggregate amount of such benefits to be provided with respect to an employee exceeds $50,000. Accordingly, under the Act, the $50,000 limit applies with respect to the aggregate of self-insured and insured life insurance benefits under all funds maintained by the employer. The Act does not change the rules of the 1984 Act under which certain post-retirement life insurance benefits in excess of $50,000 may be taken into account in determining the account limit for certain individuals under plans in existence on January 1, 1984 (1984 Act sec. 223(d)(2)).

f. Actuarial certification

Prior Law

The 1984 Act provided that the account limit for a qualified asset account (reserve) for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Claims incurred but unpaid include claims incurred but unreported as well as claims reported but unpaid. The time at which claims are incurred is the time at which the employee becomes entitled to the benefits, i.e., the time at which the fund becomes liable for the claims. Under the 1984 Act, insurance premiums, whenever payable, are not regarded as claims incurred but unpaid.

Unless there is an actuarial certification with respect to benefits other than (1) post-retirement medical benefits or post-retirement life insurance benefits or (2) supplemental unemployment compensation (SUB) or severance pay benefits, the account limit for a welfare benefit fund is not to exceed certain safe-harbor limits.

In the case of short-term disability benefits, the safe-harbor limit is 17.5 percent of the qualified direct costs for the immediately preceding year with respect to such benefits. A short-term disability is a disability that has persisted for at least 2 weeks and is not a long-term disability. A long-term disability is a disability that (1) has persisted for at least 5 months, and (2) a medical evaluation determines that such disability is expected to last for at least 12 months.

The legislative history of the 1984 Act provides that no more than 5 months of benefit payments are to be deemed to have been incurred with respect to short-term disabilities.

Explanation of Provision

The Act provides that the requirement for an actuarial certification also applies to post-retirement medical benefits and post-retirement life insurance benefits, unless a safe harbor computation is used.

Congress clarified the application of the account limit rules to short-term disability. Because a disability that is expected to last more than 5 months, but less than 12 months, is not treated as a long-term disability, Congress intends that the legislative history of the 1984 Act will not prohibit the funding of up to 12 months of benefit payments for short-term disabilities that are expected to last more than 5 months.

g. Aggregation of funds

Prior Law

In addition to the limits provided by the 1984 Act with respect to post-retirement medical benefits provided under a welfare benefit fund, the 1984 Act dollar limits were provided with respect to the amount of life insurance benefits, disability benefits, and supplemental unemployment compensation benefits or severance pay benefits for which a reserve may be accumulated for any participant. The 1984 Act did not specify that these limits apply to the aggregate of reserves under all funds of an employer rather than on a fund-by-fund basis. Also, in the case of life insurance benefits, that Act did not specify that the limit on reserves is to be applied to the aggregate of insured and self-insured benefits.

Explanation of Provision

The Act provides that, in computing the dollar limits applicable to the amount of reserves for disability benefits, post-retirement medical benefits, and post-retirement life insurance benefits for which reserves may be accumulated for any participant, all welfare benefit funds of an employer are treated as a single fund. In the absence of Treasury regulations to the contrary, the limit is allocated proportionately to the amount of the death benefit in each plan.

h. Transition rules

Prior Law

The account limit for any of the first four taxable years to which the rules for welfare benefit funds apply is increased by the applicable percentage of any existing excess reserve. In particular, the 1984 Act provided that, for the first year, the limit is to be the sum of (1) the limit determined without regard to the transitional rule, and (2) 80 percent of the existing excess reserve amount. For the second, third, and fourth succeeding years, 60, 40, and 20 percent, respectively, is substituted for 80 percent. The 1984 Act did not clearly provide that the existing excess reserve for any year is to be the excess of (1) the amount of assets set aside to provide disability, medical, SUB, severance pay, or life insurance benefits under a plan and fund to provide a benefit in existence on July 18, 1984, as of the close of the first taxable year ending after that date, over (2) the account limit determined, for the year the computation is being made, without regard to the transitional rule.

Explanation of Provision

The Act provides that, under the transition rules for existing excess reserves, the amount of existing excess reserves for any year is the excess (if any) of (1) the amount of assets set aside at the close of the first taxable year ending after July 18, 1984, to provide disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits, over (2) the account limit (without regard to the transition rules) for the taxable year for which the excess is being computed. The Act further provides that the transition rule allowing an increase in the account limit because of existing excess reserves applies only to a welfare benefit fund which, on July 18, 1984, had assets set aside to provide the enumerated benefits.

Accordingly, in the case of an employer that maintains a funded plan which had assets set aside to provide disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits on July 18, 1984, and to which the deduction limits first apply for the taxable year beginning January 1, 1986, the increase in the account limit for 1986 attributable to existing excess reserves is 80 percent of the excess, if any, of the amount of assets set aside at the close of 1984 (the first taxable year ending after July 18, 1984) over the account limit determined under the general rules for 1986. For 1987, however, the increase attributable to existing excess reserves is 60 percent of the excess, if any, of the amount of assets set aside at the close of 1984 over the account limit determined for 1987.

i. Tax on unrelated business income

Prior Law

Under prior and present law, the tax on unrelated business taxable income of a social club, VEBA, SUB, or group legal service organization applies to an amount equal to the lesser of the income of the fund or the amount by which the assets in the fund exceed a specific limit on amounts set aside for exempt purposes. The limit on the amount that may be set aside for a year is generally not to increase the total amount that is set aside to an amount in excess of the account limit for the taxable year determined under the deduction limits.

The limitation on the amount that may be set aside for purposes of the unrelated business income tax does not apply to income attributable to certain existing reserves for post-retirement medical or post-retirement life insurance benefits. Under the 1984 Act, this exclusion applies only to income attributable to the amount of assets set aside, as of the close of the last plan year ending before July 18, 1984, for purposes of providing such benefits.

In addition, the 1984 Act provided for the inclusion of a similar amount (deemed unrelated income) in the gross income of an employer who maintains a welfare benefit fund that is not exempt from income tax. It was anticipated that Treasury regulations would provide that deemed unrelated income will be treated in a manner that will not subject the same income to tax more than once.

Explanation of Provision

The Act makes it clear that the tax on unrelated business income applies in the case of a 10-or-more employer plan. Under the Act, the account limit is to be determined as if the rules limiting deductions for employer contributions applied.

In addition, the Act provides that the transition rule for pre-existing reserves for post-retirement medical and life insurance benefits applies to the greater of the amount of assets set aside as of (1) July 18, 1984, or (2) the close of the last plan year ending before July 18, 1984, rather than only to assets set aside as of the end of the plan year ending before July 18, 1984.

The Act deletes the provision of the Code barring a set aside for certain assets used in the provision of permissible benefits (facilities). Treasury regulations are to provide that facilities used to provide permissible benefits are disregarded in determining whether fund assets exceed the account limit for a qualified asset account.

In addition, the Act provides that if any amount is included in the gross income of an employer for a taxable year as deemed unrelated income with respect to a welfare benefit fund, then the amount of the income tax imposed on the deemed unrelated income is to be treated as a contribution paid by the employer to the fund on the last day of the taxable year and, thus, is deductible, subject to the limits on deductions for fund contributions. The tax attributable to the deemed unrelated income is to be treated as if it were imposed on the fund for purposes of determining the after-tax income of the fund.

j. Tax on disqualified benefits provided under funded welfare benefit plans

Prior Law

Under the 1984 Act, if a welfare benefit fund (other than an arrangement funded exclusively by employee contributions) provides a disqualified benefit during a taxable year, then an excise tax is imposed for that year on each employer who maintains the fund. The tax is equal to 100 percent of the disqualified benefit.

Under the 1984 Act, a disqualified benefit is (1) any medical benefit or life insurance benefit provided with respect to a key employee other than from a separate account required under the rules limiting employer deductions with respect to welfare benefit funds, (2) any post-retirement medical or life insurance benefit unless the plan meets the requirements of the nondiscrimination rules of the 1984 Act for benefits under a welfare benefit fund, or (3) any portion of a welfare benefit fund reverting to the benefit of the employer. A portion of a welfare benefit fund is not considered to revert to the benefit of an employer merely because it is applied, in accordance with the plan, to provide welfare benefits to employees or their beneficiaries. Also, amounts returned to employees that represent the employees' contributions to the fund are not treated as amounts reverting to the benefit of the employer and, therefore, are not subject to the tax on disqualified benefits.

Explanation of Provision

With respect to benefits required to be paid from a separate account, the Act defines the term "disqualified benefit" to mean any post-retirement medical benefit or post-retirement life insurance benefit provided with respect to a key employee if a separate account is required to be established for the employee and the payment is not from such an account. Accordingly, pre-retirement benefits would not be considered to be disqualified benefits under the Act merely because they are paid to a key employee from a source other than a separate account.

In addition, under the Act, a post-retirement medical benefit or post-retirement life insurance benefit provided by a fund with respect to an individual in whose favor discrimination is prohibited is a disqualified benefit unless the plan meets the nondiscrimination requirements of the 1984 Act with respect to the benefit (sec. 505(b)), whether or not the nondiscrimination requirements apply in determining the tax-exempt status of the fund from which the benefit is provided.

Under the Act, if a plan is not exempt from the nondiscrimination rules under the rules for collectively bargained plans, a discriminatory benefit is a disqualified benefit subject to the excise tax even though no discrimination test applies for purposes of determining the exempt status of the fund from which the benefit is provided. A benefit is not subject to the nondiscrimination requirements if it is provided under a plan maintained pursuant to a collective bargaining agreement between one or more employee representatives and one or more employers if the Secretary of the Treasury finds that the agreement is a collective bargaining agreement and that post-retirement medical benefits or post-retirement life insurance benefits (as the case may be) were the subject of good faith bargaining between the employee representatives and the employer or employers.

Further, under the Act, a payment that reverts to the benefit of an employer is not a disqualified benefit to the extent it is attributable to an employer contribution with respect to which no deduction is allowable in the current or any preceding taxable year or to an employee contribution. As under current law, the excise tax on disqualified benefits is inapplicable to welfare benefit contributions funded solely by employees. A reduction is to be made to the amount treated as a carryover (sec. 419(d)) to the extent that any nondeducted contribution reverts to the benefit of an employer. Any amounts reverting to the benefit of an employer are treated as coming first out of nondeducted contributions for purposes of this rule.

Also, the Act provides that a benefit that would otherwise be a disqualified benefit because it does not meet the separate-account

rule or because it is discriminatory is not a disqualified benefit if it is a post-retirement benefit that is charged against an existing reserve (or against any income properly allocable to an existing excess reserve) for post-retirement medical or post-retirement life insurance benefits as provided under the transition rules of the 1984 Act applicable to the unrelated business income tax (Code sec. 512(a)(3)).

k. Application of account limits to collectively bargained plans

Prior Law

The 1984 Act provided that, by July 1, 1985, the Secretary of the Treasury was to publish regulations establishing special reserve limit principles with respect to funded welfare benefit plans maintained pursuant to a collective bargaining agreement. In establishing these limits, the Treasury was to presume that reserves in such plans were not excessive because of the arm's-length negotiations between adversary parties inherent in the collective bargaining process. Further, because contributions under collectively bargained plans are often fixed over a multiyear period on the basis of economic assumptions that may be inaccurate and because such contributions may be the only source of benefits to be provided during layoffs, strikes, lockouts, and economic recession, these special limits were to allow substantial flexibility with respect to the account limits.

On July 1, 1985, Treasury regulations were published providing that the account limits under the normal rules for welfare benefit funds do not apply to collectively bargained funds until a specified period of time after the issuance of regulations specifying the higher limits applicable to such collectively bargained funds. Thus, pending the issuance of such regulations, employer contributions to a collectively bargained fund for disability, medical, SUB or severance, or life insurance benefits held in VEBA are deductible (without limit) and earnings on fund assets are tax exempt.

Explanation of Provision

The Act permanently exempts collectively bargained welfare benefit funds from the account limits applicable to welfare benefit funds without regard to any Treasury regulations providing special account limits for such funds. Thus, employer contributions to such funds for disability, medical, SUB or severance, or life insurance benefits are deductible and earnings on assets of such funds held in a VEBA are tax exempt.

l. Application of account limits to welfare benefit plans funded solely with employee contributions

Prior Law

Under prior and present law, the account limits for welfare benefit funds apply whether a plan is funded with employer or employee contributions. In the case of a plan funded solely by employee contributions, the primary effect of the account limits is to treat earnings on plan assets in excess of the account limits as unrelated business taxable income.

Explanation of Provision

The Act exempts certain VEBAs funded solely with employee contributions from the account limits applicable to welfare benefit funds. This exemption is available only if (1) the VEBA covers at least 50 employees, and (2) other than current insurance protection, the only amounts payable to employees as experience-rated refunds or policy dividends are not guaranteed and are determined, in part, by factors other than the amount of welfare benefits paid to (or on behalf of) the employee or the employee's beneficiaries. Thus, in order for the exemption to apply, the amounts contributed by an employee are required to be subject to a significant risk of current economic loss.

Under the Act, an employee pay-all VEBA is not considered to fail to qualify for this exemption merely because an employee's refund or rebate may vary depending upon the number of years the employee contributed to the fund. For example, if a VEBA provides a set employee contribution rate that applies for 3 years, the mere fact that an employee who contributes for 3 years may receive a larger refund or rebate than an employee who contributes for less than 3 years does not cause the fund to fail to meet the requirements for exemption as long as there is a significant current risk of economic loss (i.e., the amount of the refund or rebate is also determined, in part, by factors other than any employee's experience).

m. Effective dates

Prior Law

The 1984 Act provided that the new limits on deductions under welfare benefit funds generally apply to contributions paid or accrued after December 31, 1985, in taxable years ending after that date. Special effective dates were provided for contributions with respect to facilities and for certain collectively bargained plans. The effective dates for the provisions relating to the tax on unrelated business income and the excise tax on disqualified benefits were unclear under the 1984 Act.

A transition rule for existing excess reserves was provided with respect to the account limit for any of the first four years to which the rules for welfare benefit funds apply. The existing excess reserve for any year is the excess of (1) the amount of assets set aside to provide disability, medical, SUB, severance pay, or life insurance benefits under a plan and fund to provide such a benefit in existence on July 18, 1984, as of the close of the first taxable year ending after that date, over (2) the account limit determined, for the year for which the computation is being made, without regard to the transitional rule.

Explanation of Provision

The Act provides that the rules of the 1984 Act relating to the tax on disqualified benefits generally apply to benefits provided after December 31, 1985. Under the Act, however, the tax on disqualified benefits does not apply to benefits charged against an existing reserve for post-retirement medical benefits or post-retirement life insurance benefits (as defined under the transition rules (sec. 512(a)(3))) applicable to the unrelated business income tax.

The Act clarifies that the amendments made by the Act with respect to the tax on unrelated business income are effective for taxable years ending after December 31, 1985, and are to be treated as a change in the rate of income tax imposed for purposes of Code section 15.

Further, Congress intended that the transition rule for existing excess reserves first applies to the first taxable year for which the 1984 Act is effective. Thus, the phaseout of existing excess reserves does not apply to any taxable year before the first taxable year to which the 1984 Act applies.

2. Treatment of Deferred Compensation Arrangements and Deferred Benefits (sec. 1851(b) of the Act and sec. 512 of the Code)

a. Transition rule for certain taxpayers with fully vested vacation pay plans

Prior Law

Under prior and present law, any plan, method, or arrangement providing for deferred benefits for employees, their spouses, or their dependents is treated as a plan deferring the receipt of compensation (deferred benefit plan). The 1984 Act provided that a deferred benefit plan includes an extended vacation pay plan, i.e., a plan under which employees gradually, over a period of years, earn the right to additional vacation that cannot be taken until the end of the period. Similarly, a vacation pay plan under which employees can delay the vacation (and also the income inclusion) beyond the current taxable year is a deferred benefit plan. However, any vacation benefit to which an election applies under section 463 (relating to accrual of vacation pay) is not considered a deferred benefit.

The provision of the 1984 Act was effective for amounts paid or incurred after July 18, 1984, in taxable years ending after that date.

Explanation of Provision

The Act provides a transition rule in the case of a fully vested vacation pay plan in which payments is expected to be paid within one year after the accrual of the vacation (or are, in fact, paid). If the taxpayer makes an election under section 463 for the taxpayer's first taxable year ending after July 18, 1984, then, in lieu of establishing a suspense account under section 463, the election is treated as a change in the taxpayer's method of accounting and the adjustments required under section 481 are taken into account.

Under the Act, the time for making a section 463 election is extended to April 22, 1987, in the case of a taxpayer otherwise eligible for the transition rule.

b. Clarification of the scope of the deduction-timing rules applicable to deferred compensation arrangements

Prior Law

Under prior and present law, an arrangement for compensation or benefits having the effect of a plan or method deferring the receipt of compensation is subject to the deduction-timing rules applicable to deferred compensation plans (sec. 404(a)(5)). In order to be subject to the deduction rules of section 404(a), a plan or method deferring compensation must satisfy the conditions for deductibility under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for production of income).

Explanation of Provision

The Act clarifies that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation regardless of the section under which the amounts might otherwise be deductible and that the amounts shall be deductible under section 404(a)(5) and shall not otherwise be deductible under any other section. This provision also applies for purposes of determining an employer's deduction with respect to a foreign deferred compensation plan (sec. 404A) and a welfare benefit fund (sec. 419). This clarification is necessary to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction for such deferred compensation. Further, this clarification conforms the treatment of deferred compensation with the treatment of losses, expenses, and interest with respect to transactions between related taxpayers (as amended by the 1984 Act).

3. Qualified Pension, Profit-Sharing, and Stock Bonus Plans

a. Distribution rules (secs. 1852(a) and (b) of the Act and secs. 72, 401, 402, 403, and 408 of the Code)

Prior Law

Distributions prior to age 59½

Prior to DEFRA, the Code imposed an additional 10-percent income tax on distributions made to key employees in a top-heavy plan prior to age 59½, death, or disability. DEFRA provided that the additional tax applied to 5-percent owners (rather than key employees), but only to the extent that the distribution was attributable to contributions made or benefits accruing in years in which the participant was a 5-percent owner (as defined in sec. 416(i)).

Before-death distribution rules

DEFRA amended the minimum distribution rules to provide that a trust is not a qualified trust unless the plan of which it is a part provides that the entire interest of the employee will be distributed no later than the required beginning date. Alternatively, the requirements of DEFRA may be satisfied if the entire interest is to be distributed (in accordance with Treasury regulations), beginning

no later than the required beginning date, over (1) the life of the employee, (2) the lives of the employee and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the employee, or (4) a period (which may be a term certain) not extending beyond the life expectancies of the employee and a designated beneficiary.

Under prior and present law, the required beginning date is generally April 1 of the calendar year following the calendar year in which (1) the employee attains age 70½ or (2) the employee retires, whichever is later. If an employee is a 5-percent owner (as defined in sec. 416(i)) with respect to the plan year ending in the calendar year in which the employee attains age 70½, then the required beginning date is generally April 1 of the calendar year following the calendar year in which the employee attains age 70½, even though the employee has not retired. DEFRA did not, however, require the distribution to a 5-percent owner of employer securities subject to the 84-month holding period of section 409(d) before the expiration of the 84-month period.

Under prior and present law, benefits provided under a qualified plan are required to be for the primary benefit of an employee, rather than the employee's beneficiaries. Accordingly, any death benefits provided for a participant's beneficiaries are required to be incidental.[1] Under this incidental death benefit rule, a qualified plan generally is required to provide for a form of distribution under which the present value of the retirement benefit payments projected to be made to the participant, while living, is more than 50 percent of the present value of the total payments projected to be made to the participant and the participant's beneficiaries. The incidental death benefit rule is designed to limit the use of qualified plans for nonretirement purposes (e.g., to provide for deferral of income tax or to provide for tax-favored transfers of wealth).

The before-death distribution rules under prior and present law for IRAs are similar to the before-death distribution rules provided for qualified plans and are applied separately to each IRA owned by an individual.

After-death distribution rules

DEFRA provided rules that apply in the case of an employee's death before the employee's entire interest has been distributed. Under DEFRA, if distributions have commenced to the employee before death, then the remaining portion of the employee's interest is to be distributed at least as rapidly as under the method of distribution in effect prior to death. If distributions have not commenced before the participant's death, DEFRA provided permissible periods over which the remaining interest may be paid to a designated beneficiary. In either case, a plan may allow a beneficiary to accelerate payments of the remaining interest.

Similar rules are provided for after-death distributions from or under an individual retirement account or annuity. In addition, the rules applicable to after-death distributions under an annuity contract apply to a custodial account that is treated as a tax-sheltered

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[1] See, e.g., Rev. Rul. 72-241, 1972-1 C.B. 108

annuity contract (sec. 403(b)(7)). Other tax-sheltered annuity contracts are subject to the after-death distribution rules applicable to annuity contracts (sec. 72(s)).

Qualifying rollover distributions

Under DEFRA, distributions of less than the balance to the credit of an employee under a qualified plan or a tax-sheltered annuity contract may be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution is permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary.

Explanation of Provisions

Distributions prior to age 59½

Under the Act, the 10-percent additional income tax on distributions prior to age 59½, death, or disability (within the meaning of sec. 72(m)(7)) applies to amounts received from or under a qualified plan by a 5-percent owner. However, the Act provides that the tax does not apply to benefits accrued before January 1, 1985. For purposes of applying the rule, distributions will be deemed to be made first out of benefits accrued before January 1, 1985.

The Act removes the requirement of prior law that each plan distribution is to be examined to determine whether it is attributable to contributions made or benefits accruing while the participant was a 5-percent owner. Instead, the Act provides that the status of an individual at the time of a plan distribution is the relevant factor for imposition of the tax.

The Act defines a 5-percent owner as any individual who at any time during the 5 plan years preceding the plan year in which the distribution is made was a 5-percent owner (within the meaning of sec. 416(i)(1)(B)).

Before-death and after-death distribution rules

The Act clarifies the required beginning date for distributions. As noted above, under prior and present law, in the case of a 5-percent owner, distributions from a qualified plan are to commence no later than April 1 of the calendar year following the year in which the 5-percent owner attains age 70½. Subject to a transition rule,[2] the Act clarifies that an individual is considered to be a 5-percent owner for a calendar year if the individual was a 5-percent owner (within the meaning of section 416(i)(1)(B)) at any time during the plan year ending in the calendar year in which the individual attains age 70½, or during any of the four preceding plan years. The Act also clarifies that if an employee becomes a 5-percent owner in a plan year subsequent to the plan year ending in

[2] A technical correction may be needed so that the statute reflects the intended transition rule. Such a correction was included in the versions of H. Con. Res. 95 which passed the House and Senate in the 99th Congress.

the calendar year in which the employee attained age 70½, the required beginning date is April 1 of the calendar year following the calendar year in which ends the plan year that the employee becomes a 5-percent owner.

The Act clarifies that distributions from IRAs are to commence no later than April 1 of the calendar year following the year in which the owner of the IRA attains age 70½, without regard to whether the owner has retired. In addition, the Act clarifies that distributions from IRAs are subject to the incidental death benefit rules applicable to qualified plans.

Under the Act, tax-sheltered annuity contracts (including custodial accounts (sec. 403(b)(7) and retirement income accounts (sec. 403(b)(9)) are required to satisfy minimum distribution requirements similar to those applicable to qualified plans. Tax-sheltered annuity contracts are also subject to an incidental death benefit rule similar to the one applicable to qualified plans. The minimum distribution requirements and the incidental death benefit rule apply to benefits accruing under a tax-sheltered annuity contract after December 31, 1986. Thus, the benefit accrued as of December 31, 1986, may be disregarded in determining whether the new distribution rules have been satisfied.

The Act repeals the exception to the required distribution rules applicable to amounts held by an ESOP that are subject to the 84-month rule (sec. 409(a)). Instead, the Act provides an exception to the 84-month rule for amounts required to be distributed under the required distribution rules for qualified plans.

Further, the Act provides that amounts required to be distributed under the required distribution rules are not eligible for rollover treatment. This rule ensures that an individual will not be able to circumvent the required distribution rules by taking a required distribution at year's end and rolling over that distribution before or after the beginning of the next year. This restriction applies only to the amounts required to be distributed. Thus, individuals would not be prevented from rolling over those distributions that (1) exceed the minimum required distribution, or (2) occur during a year in which no minimum distribution is required. For this purpose, the first amounts distributed to an individual during a taxable year are treated as amounts required to be distributed.

Qualifying rollover distributions

The Act clarifies that the distribution of the entire balance to the credit of an employee in a qualified plan may be treated as a distribution eligible for rollover under the partial distribution rollover rules, so long as such distribution does not constitute a "qualified total distribution." Thus, a total distribution that is not made on account of plan termination, is not eligible for lump sum treatment and does not consist of accumulated deductible employee contributions, would be eligible for rollover under the partial distribution rollover rules.

The Act clarifies that accumulated deductible employee contributions (within the meaning of sec. 72(o)(5)) are not taken into account for purposes of calculating the balance to the credit of an employee under the partial distribution rollover rules. In addition, the Act clarifies that a self-employed individual is generally treated as an employee for purposes of the rules governing the tax treatment of distributions, including the rules relating to rollover distributions.

The Act provides that the rules relating to rollovers in the case of a surviving spouse of an employee who received distributions after the employee's death apply to permit rollovers to an IRA but not to another qualified plan. Also, the Act clarifies that partial distributions are to be rolled over within 60 days of the distribution to be eligible for rollover under the partial distribution rollover rules.

b. Treatment of distributions if substantially all contributions are employee contributions (sec. 1852(c) of the Act and sec. 72 of the Code)

Prior Law

Under DEFRA, if substantially all of the contributions under a qualified plan are employee contributions, then distributions under the plan will be considered to be income until all income has been distributed. In addition, if an employee received (directly or indirectly) any amount as a loan under the plan, DEFRA treats the amount of the loan as an amount distributed from the plan.

Under prior law, a plan in which substantially all of the contributions are employee contributions was defined as a plan with respect to which 85 percent of the total contributions during a representative period (such as 5 years), as determined under Treasury regulations, were employee contributions (whether or not mandatory).

Explanation of Provision

Under the Act, a plan is defined as one in which substantially all of the contributions are employee contributions if 85 percent or more of the total contributions during a representative period are employee contributions. Also, the Act provides that the 5-percent additional income tax on premature distributions from annuity contracts does not apply to distributions from a plan substantially all of the contributions of which are employee contributions.

The Act clarifies that deductible employee contributions are not taken into account as employee contributions for purposes of testing whether 85 percent or more of the total contributions to a plan during a representative period are employee contributions.

c. Provisions relating to top-heavy plans (sec. 1852(d) of the Act and sec. 416 of the Code)

Prior Law

Additional qualification standards are provided with respect to a qualified plan that is top heavy. These rules are designed to provide safeguards for rank-and-file employees and to curb abuse of the special tax incentives available under qualified plans. These rules (1) limit the amount of a participant's compensation that may be taken into account; (2) require accelerated vesting; (3) provide minimum nonintegrated benefits or contributions for plan participants who are not key employees; and (4) reduce the overall limit on contributions and benefits for certain key employees.

A qualified plan is top heavy if, as of the determination date, more than 60 percent of the value of cumulative accrued benefits under the plan is allocable to key employees. Under prior law, the cumulative accrued benefits of any individual who had not received any compensation from any employer maintaining a plan during a period of 5 plan years ending on the determination date could be disregarded for purposes of determining whether the plan was top heavy.

DEFRA provided that the additional standards for top-heavy plans do not apply to a governmental plan (as defined in sec. 414(d)), but did not clarify whether State or local government employees may be considered key employees for purposes of other nondiscrimination provisions (e.g., sec. 79).

Explanation of Provision

The Act amends the definition of a key employee to exclude any individual who is an officer or employee of an entity described in section 414(d) (relating to governmental plans). The effect of this provision is to clarify that certain separate accounting and nondiscrimination provisions of the Code (e.g., secs. 79, 415(l), and 419A) do not apply to employees of a State or local government or certain other governmental entities. The Act does not repeal the provision that exempts governmental plans from the top-heavy plan requirements.

The Act also provides that the rule disregarding benefits of an employee after 5 plan years applies to employees who have not performed services for the employer maintaining the plan at any time during the 5-year period ending on the determination date. This provision is added to relieve the administrative difficulties associated with determining whether or not amounts an individual might receive after separation from service are in the nature of compensation.

d. Provisions relating to estate and gift taxes with respect to qualified plan benefits (sec. 1852(e) of the Act and secs. 2039 and 2517 of the Code)

Prior Law

Under prior law, if the spouse of an employee on whose behalf employer contributions or payments were made to a qualified plan or a tax-sheltered annuity predeceased the employee spouse, the decedent spouse's estate did not include any community property interest in the employee spouse's interest in the employer-derived benefits under the qualified plan or tax-sheltered annuity. A similar rule applied for purposes of the effect of certain transfers under the gift tax provisions.

DEFRA repealed a separate $100,000 limit on the estate tax exclusion (prior to TEFRA, the exclusion had been unlimited) for retirement benefits under qualified plans, tax-sheltered annuities, IRAs, and certain military retirement plans. Under DEFRA, a grandfather rule applied to both the repeal of the exclusion and the reduction of the exclusion to $100,000 in TEFRA. This grandfather rule applied to any decedent (1) whose benefit was in pay status on December 31, 1984 (December 31, 1982, in the case of the TEFRA grandfather), and (2) who, prior to July 18, 1984 (January 1, 1983, in the case of the TEFRA grandfather), had made an irrevocable election to designate the form of the retirement benefit distribution (including the form of any survivor benefit).

In addition, prior law provided that the exercise or nonexercise by an employee of an election or option pursuant to which an annuity became payable to a beneficiary under a qualified plan, a tax-sheltered annuity, an IRA, or certain military pensions was not considered a transfer for purposes of the gift tax provisions.

Explanation of Provision

Under the Act, the special community property rules applicable to qualified plans and tax-sheltered annuities for purposes of the estate and gift tax provisions are repealed. However, the Act clarifies that, if a transfer is made to an employee spouse by a nonemployee spouse in a community property state, the amount transferred is eligible for the unlimited marital deduction (secs. 2056 and 2523).

The Act also repeals the general exemption from the gift tax provisions of transfers pursuant to the exercise or nonexercise by an employee of an election or option under a qualified plan, etc.

The Act modifies the grandfather rules applicable to the repeal of the estate tax exclusion under DEFRA (and the reduction of the exclusion under TEFRA) to provide that, with respect to an employer-maintained plan (but not an IRA), as long as the other conditions for the grandfather are satisfied, an individual is to be treated as having made an irrevocable election and as being in pay status within the required time with respect to a form of benefit if (1) the individual separated from service before January 1, 1985 (January 1, 1983 in the case of the TEFRA grandfather), and (2) the individual does not change such form of benefit before death.

The provision of the Act relating to the repeal of the special rules for community property applies to gifts made or decedents dying after October 22, 1986.

e. Affiliated service groups and employee leasing arrangements (sec. 1852(f) of the Act and sec. 414 of the Code)

Prior Law

Under DEFRA, the Secretary was granted regulatory authority to develop rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing or affiliated service group provisions apply through the use of separate organizations, employee leasing, or other arrangements (Code sec. 414(o)).

Explanation of Provision

Under the Act, the special regulatory authority provided to the Secretary to prevent avoidance of the affiliated service group provisions through the use of separate organizations (sec. 414(m)(7)) is

repealed in favor of the broader general authority provided under DEFRA (sec. 414(o)). In addition, the Act clarifies that the other definitions relating to affiliated service groups (sec. 414(m)(6)) continue to apply.

f. Discrimination standards applicable to cash or deferred arrangements (sec. 1852(g) of the Act and sec. 401(k) of the Code)

Prior law

DEFRA required that the actual deferral percentage of a participant under all cash or deferred arrangements of an employer be added together for purposes of calculating that participant's actual deferral percentage for each cash or deferred arrangement.

In addition, under prior and present law, a cash or deferred arrangement is a qualified cash or deferred arrangement only if it meets the special tests provided by the Code relating to actual deferral percentages. If a cash or deferred arrangement fails to meet the special tests, an elective deferral made under the arrangement is treated as an employee contribution under the plan which is not excluded from gross income, but the plan of which the arrangement is a part is not to be disqualified if it meets the usual qualification requirements, including the general nondiscrimination rules.

Explanation of Provision

Under the Act, if an employee participates in more than one cash or deferred arrangement of an employer, all such cash or deferred arrangements are treated as one arrangement for purposes of determining the employee's actual deferral percentage. Thus, an employee's actual deferral percentage taken into account for purposes of applying the special deferral percentage tests under any plan of the employer is the sum of the elective deferrals for that employee under each plan of the employer that provides a cash or deferred arrangement, divided by the participant's compensation from the employer.

In addition, the Act clarifies that a plan that includes an otherwise qualified cash or deferred arrangement that satisfies the special tests provided by section 401(k)(3) will be treated as satisfying the general nondiscrimination test of section 401(a)(4) with respect to the elective deferrals.

g. Treatment of certain medical, etc., benefits under section 415 (sec. 1852(h) of the Act and secs. 401(h) and 415 of the Code)

Prior Law

Under DEFRA, any defined benefit pension plan that provides medical benefits to retired employees was required to create and maintain an individual medical benefit account for any participant who was a 5-percent owner (within the meaning of sec. 416(i)(1)(B)) and to treat contributions allocated to such accounts as annual additions for purposes of the limits on contributions and benefits. Under prior and present law, a similar rule, applicable to post-retirement medical benefits provided through a welfare benefit fund, requires separate accounting for all key employees.

Under the limits on contributions, the annual addition with respect to an employee under all defined contribution plans of an employer for a year is not to exceed the lesser of $30,000 or 25 percent of compensation. A lower limit may apply if the employer also maintains a defined benefit plan for the employee. The 25-percent limit prevented reserve additions for a retired employee who had no compensation.

Explanation of Provision

The Act clarifies that the special rules for post-retirement medical benefits apply to any pension or annuity plan under which such benefits are provided.

In addition, the Act provides that separate accounting is required under a pension or annuity plan with respect to any employee who is a key employee (within the meaning of section 416(i)). This conforms the separate accounting requirement for pension or annuity plans to the requirement for post-retirement medical and life insurance benefits under a welfare benefit fund.

Further, the Act provides that the amount treated as an annual addition under the rules for coordinating the post-retirement medical benefits with the limits on qualified plans is not subject to the 25-percent-of-compensation limit usually applicable to annual additions.

For example, assume an employee's compensation is $100,000 for a year and a $5,000 contribution is made to the employee's individual medical benefit account under a pension plan. Such $5,000 is treated as an annual addition for purposes of the limits applicable to qualified plans. Assume further that the annual addition for the year under a qualified defined contribution plan, without regard to the post-retirement medical benefit, is $25,000 (a contribution equal to the maximum percentage of compensation limit). Under the Act, the annual addition for post-retirement medical benefits does not cause the annual addition to exceed the 25-percent limit on annual additions, even though the annual addition would exceed that limit if the amount added for post-retirement medical benefits were taken into account. The annual addition of $30,000 would, however, be subject to the separate dollar limit applicable to defined contribution plans for the year. Also, if the employer maintains a defined benefit plan for the employee, the full annual addition of $30,000 would be taken into account in determining whether the combined plan limits are satisfied (sec. 415(e)). However, under rules prescribed by the Secretary, the defined contribution fraction is to be adjusted to take into account the fact that contributions to an individual medical benefit account are not to cause the percentage of compensation limit to be exceeded.

h. Transition rules for effective date of multiemployer pension plan amendments act of 1980 (sec. 1852(i) of the Act and sec. 4402 of the Employee Retirement Income Security Act of 1974)

Prior Law

The Multiemployer Pension Plan Amendments Act of 1980 (MPPAA) was enacted on September 26, 1980. Under the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended by MPPAA, liability generally was imposed on an employer who withdrew from a multiemployer defined benefit pension plan. The withdrawal liability provisions of the MPPAA generally applied retroactively to withdrawals after April 28, 1980.

The Deficit Reduction Act of 1984 (DEFRA) eliminated the retroactive aspect of MPPAA so that, in general, any liability incurred by an employer under the withdrawal liability provisions of ERISA, as a result of the complete or partial withdrawal from a multiemployer plan before September 26, 1980, is void.

Explanation of Provision

The Act modifies the effective date of the withdrawal liability provisions of MPPAA in two instances. First, in the case of an employer who entered into a collective bargaining agreement that was effective on January 16, 1979, and that remained in effect through May 15, 1982, and under which contributions to a multiemployer plan were to cease on January 16, 1982, the Act changes the effective date of the withdrawal liability provision of MPPAA from September 26, 1980 to January 16, 1982.[3]

Second, in the case of an employer engaged in the grocery wholesaling business that had ceased all covered operations under the plan before June 30, 1981, and had relocated its operations to a new facility in another State and that meets certain other conditions listed in the Act, the Act modifies the effective date of the withdrawal liability provisions of MPPAA from September 26, 1980 to June 30, 1981.

4. Fringe Benefit Provisions (sec. 1853 of the Act, sec. 531 of the Tax Reform Act of 1984, and secs. 117(d), 125, 132, and 4977 of the Code)

a. Clarification of line of business requirement

Prior Law

Section 132(a)(2) excludes from income certain employee discounts on property or services offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services. For purposes of the discount exclusion, a leased section of a department store is treated as part of the line of business of the person operating the store and employ-

[3] A technical correction may be needed so that the statute reflects the intent that the references be to January 16, 1979, and January 16, 1982, rather than to January 12, 1979, and January 12, 1982, respectively. Such a correction was included in the versions of H. Con. Res. 395 which passed the House and Senate in the 99th Congress.

ees of the leased section are treated as employees of that person. A leased section of a department store is defined as any part of a department store where over-the-counter sales of property are made and certain other conditions are satisfied.

Explanation of Provision

The Act clarifies that a part of a department store that, in connection with the offering of beautician services, customarily sells beauty aids in the ordinary course of business is to be treated as engaged in over-the-counter sales of property. Thus, if such part of the department store meets the other requirements for leased-section status, such part of the department store is to be treated as a leased section. Congress intended that this treatment is to be available without requiring that a specific percentage of the beauty salon's revenue be earned through the sale of such beauty products because beauty salons have traditionally occupied such leased sections (even though the bulk of their revenue is attributable to performing services rather than selling property). This is contrasted with businesses (such as insurance companies) that have not traditionally occupied such leased sections.

b. Definition of dependent children

Prior Law

Section 531 of DEFRA provided exclusions from gross income for no-additional-cost services and certain other fringe benefits. These exclusions generally apply to benefits provided by an employer for use by an employee, the employee's spouse, or the employee's dependent child. Under the Consolidated Omnibus Budget Reconciliation Act of 1985, use of air transportation by an employee's parent is also eligible for the exclusion. DEFRA defined the term "dependent child" to mean any child of the employee (1) who is a dependent of the employee, or (2) both of whose parents are deceased (Code sec. 132(f)(2)(B)).

Explanation of Provision

The Act defines dependent child to mean any child of the employee (1) who is a dependent of the employee, or (2) both of whose parents are deceased and who has not attained age 25.

c. Clarification of cross-reference

Prior Law

Code section 132(f) provides that for purposes of paragraphs (1) and (2) of subsection (a), any use by the spouse or a dependent child of the employee is treated as use by the employee. The cross-references are to the no-additional-cost service exclusion (sec. 132(a)(1)), which applies to a service provided by an employer to an employee for use by such employee if certain conditions are met, and the qualified employee discount exclusion (sec. 132(a)(2)), which, under prior law, applied in certain circumstances where the price at which property or services were provided to the employee by the employer was less than the price to nonemployee customers.

Explanation of Provision

To clarify the mechanics of the cross-reference in Code section 132(f), the Act adds the words "for use by such employee" in section 132(a)(2). Accordingly, the qualified employee discount exclusion applies in certain circumstances where the price at which property or services are provided to the employee by the employer for use by such employee (or the spouse, dependent children, or parents (in the case of air transportation) of the employee) is less than the price to nonemployee customers.

d. Cross-reference in definition of customer

Prior Law

For purposes of Code section 132, other than section 132(c)(2)(B), the term "customers" only includes nonemployee customers. Section 132(c)(2)(B) relates to the determination of gross profit percentage as a limitation on the exclusion for qualified employee discounts.

Explanation of Provision

The Act provides that this exception to the definition of customers also applies for purposes of section 132(c)(2)(A), defining the term "gross profit percentage."

e. Excise tax on certain fringe benefits

Prior Law

Under prior and present law, the line of business limitation otherwise applicable to the section 132 exclusions for no-additional-cost services and qualified employee discounts is relaxed under an elective grandfather rule set forth in section 4977. For an employee discount or service to qualify for this rule, substantially all of the employees of the employer were required to have been entitled to such discount or service.

Explanation of Provision

The Act clarifies that, in the case of an agricultural cooperative incorporated in 1964, the grandfather rule, requiring that substantially all of the employees in all lines of business of an employer be eligible for the employee discount or service, is applied without taking into account employees of an entity that became a member of a controlled group including the agricultural cooperative during July of 1980.

f. Applicability of section 132(a)(1) exclusion to certain pre-divestiture retired telephone employees

Prior Law

Section 531 of the 1984 Act excludes from gross income and wages the fair market value of a no-additional-cost service provided by an employer to an employee for use by the employee (Code sec. 132(a)(1)). This exclusion applies if (1) the employer incurs no substantial additional cost (including foregone revenue) in providing the service; (2) the service is provided by the employer (including certain businesses under common control) or another business with whom the employer has a written reciprocal agreement, and is of the same type ordinarily sold to the public in the line of business in which the employee works; (3) the service is provided to a current, retired, or disabled employee; a spouse, dependent child, or parent (in the case of air transportation) of such an individual; or a widow(er) or dependent children of certain deceased employees; and (4) for certain officers, owners, and highly compensated employees, nondiscrimination requirements are met. Subject to certain transitional rules, the exclusion takes effect January 1, 1985.

Generally, situations in which an employer incurs no additional cost in providing services to employees are those in which the employees receive, at no substantial additional cost to the employer, the benefit of excess capacity that otherwise would have remained unused because nonemployee customers would not have purchased it—e.g., where telephone companies provide telephone service to employees within existing capacity. Local telephone service and long-distance telephone service are considered the same line of business.

Explanation of Provision

The provision applies a transitional rule under which the fair market value of free telephone service provided to employees of the Bell System who had retired prior to divestiture of the system on January 1, 1984 is excluded from the gross income and wages of such pre-divestiture retired employees. The exclusion pursuant to the provision does not apply to the furnishing of any property or to the furnishing of any type of service that was not furnished to such retirees as of January 1, 1984.

The provision applies in the case of an employee who, prior to January 1, 1984, separated from the service (by reason of retirement or disability) of an entity subject to the modified final judgment (as defined in DEFRA section 559(c)(4)). The provision does not apply to any employee who separated from such service on or after January 1, 1984. No inference is intended from adoption of this transitional rule as to the interpretation of the no-additional-cost service exclusion in any other circumstances.

Under the provision, all entities subject to the modified final judgment are treated as a single employer in the same line of business for purposes of determining whether telephone service provided to the employee is a no-additional-cost service. Also, payment by an entity subject to the modified final judgment of all or part of the cost of local telephone service provided to the employee by a person other than an entity subject to the modified final judgment (including rebate of the amount paid by the employee for the service and payment to the person providing the service) is treated as telephone service provided to the employee by such single employer for purposes of determining whether the telephone service is a no-additional-cost service.

For purposes of this provision, the term "employee" has the meaning given to such term in section 132(f). Except as otherwise

provided in this provision, the general requirements for the section 132(a)(1) exclusion apply; e.g., the exclusion applies to officers, owners, or highly compensated employees only if the no-additional-cost service is available to employees on a nondiscriminatory basis.

g. Cafeteria plans

Prior Law

Under prior and present law, a cafeteria plan is a plan under which employees may choose (1) taxable benefits consisting of cash or certain other taxable benefits, or (2) certain fringe benefits that are specifically excluded from gross income by the Code (statutory fringe benefits).

Under prior law, the only taxable benefits that could be offered in a cafeteria plan consisted of certain life insurance coverage that was not excludable from gross income, certain vacation pay, or cash. The life insurance coverage that could be offered was the coverage that was included in gross income to the extent the coverage exceeded $50,000 or to the extent it was provided on the life of a spouse or dependent of an employee. Vacation days could be provided under a cafeteria plan only if the plan precluded any participant from using (or receiving cash for) vacation days remaining unused as of the end of the plan year.

A cafeteria plan may offer any fringe benefit (other than scholarships or fellowships, vanpooling, educational assistance, or miscellaneous fringe benefits) that is excludable from gross income under a specific section of the Code.

Under DEFRA, both general and special transition relief is provided with respect to the Treasury cafeteria plan regulations for cafeteria plans and "flexible spending arrangements" in existence on February 10, 1984.

Explanation of Provision

Under the Act, the definition of permissible cafeteria plan benefits is clarified. The effect of the provision, which changes the reference in Code section 125 from nontaxable benefits to qualified benefits, is to (1) eliminate any possible implication that a taxable benefit provided through a cafeteria plan is nontaxable, and (2) clarify that certain taxable benefits (in addition to those permitted by DEFRA), as permitted under Treasury regulations, may be provided in a cafeteria plan.

The Act makes two changes to the transition relief provided to certain cafeteria plans under DEFRA section 531(b). The first change provides that a cafeteria plan, in existence on February 10, 1984, maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers will be granted relief under the transition rules until the expiration of the last collective bargaining agreement relating to the cafeteria plan. When a collective bargaining agreement terminates is determined without regard to any extension of the agreement agreed to after July 18, 1984. Also, if a cafeteria plan is amended to conform with either the requirements of the Act or the requirements of any cafeteria plan regulations, the amendment is not treated as a termination of the agreement.

Second, the Act provides that a cafeteria plan that suspended a type or amount of benefit after February 10, 1984, and subsequently reactivated the benefit is eligible for transition relief under either the general or special transition relief provision.

h. Working condition fringe

Prior Law

Under prior and present law, the fair market value of any property or services provided to an employee of the employer is excludable for income and employment tax purposes as a working condition fringe only if and to the extent that payment for the property or services by the employee would have been deductible by the employee as an ordinary and necessary business expense (under Code secs. 162 or 167) had the employee, rather than the employer, paid for such property or services.

Pursuant to this rule, the fair market value of the use of consumer goods that are manufactured for sale to nonemployee customers and that are provided to employees for product testing and evaluation outside the employer's premises is excluded as a working condition fringe only if (1) consumer testing and evaluation of the product is an ordinary and necessary business expense (other than as compensation) of the employer, (2) business reasons necessitate that the testing and evaluation be performed off-premises by employees (i.e., the testing and evaluation cannot be carried out adequately in the employer's office or in laboratory testing facilities), (3) the item is furnished to the employee for purposes of testing and evaluation, (4) the item is made available to the employee for no longer than necessary to test and evaluate its performance, and the item is required to be returned to the employer at completion of the testing and evaluation period, (5) the employer imposes limitations on the employee's use of the item that significantly reduce the value of any personal benefit to the employee, and (6) the employee is required to submit detailed reports to the employer on the testing and evaluation.

The fifth requirement above is satisfied, for example, if (1) the employer places limitations on the employee's ability to select among different models or varieties of the consumer product that is furnished for testing and evaluation purposes, (2) the employer's policy provides for the employee, in appropriate cases, to purchase or lease at his or her own expense the same type of item as that being tested (so that personal use by the employee's family will be limited), and (3) the employer requires that members of the employee's family generally cannot use the item. Gross income does not include the fair market value of personal use of consumer goods provided to an employee for product testing and evaluation that does not qualify under the requirements above to the extent that the employee pays or reimburses the employer for the fair market value of such personal use.

Under a special rule, the fair market value of the use of an employer-provided automobile by a full-time automobile salesperson

is, under certain circumstances, excluded from gross income as a working condition fringe.

Explanation of Provision

The Act clarifies the application of the product testing provision for purposes of the working condition fringe exclusion in the case of automobile testing. As described above, the product testing exclusion rule does not apply unless the employer imposes limitations on the employee's use of the item that significantly reduce the value of any personal benefit to the employee. If such limitations are not imposed, Congress intended that this particular requirement be satisfied if the employer charges the employee a reasonable amount for any personal use of the automobile; thus, the product testing exclusion rule applies in such a case if all the other requirements for the rule are met.

An employer is treated as having imposed a sufficient charge for any personal benefit to an employee from the use of an evaluation product if the charge exceeds the cost to the employer in making the product available to employees.

The Act also clarifies the special working condition fringe benefit rule for full-time automobile salespersons. This exception is not intended to be restricted to employees who have the formal job title of salesperson. Rather, the term is intended to apply to full-time employees of an automobile dealer who are automobile floor salespersons; automobile salesmanagers; or other employees who, as an integral part of their employment, regularly perform the functions of a floor salesperson or salesmanager, directly engage in the promotion and negotiation of sales to customers, and derive a significant part of their compensation from such activity. This provision, however, does not apply to owners of large automobile dealerships who do not customarily engage in significant sales activities.

i. Clarification of de minimis fringe benefits

Prior Law

Under Code section 132(e), gross income does not include any property or service the fair market value of which is so small that accounting for it is unreasonable or administratively impractical. Included in these de minimis fringe benefits are transit passes provided at discounts not exceeding $15 a month ($180 a year).

Explanation of Provision

Congress intended that the de minimis fringe benefit exclusion include tokens, vouchers, and reimbursements to cover the costs of commuting by public transit, as long as the amount of such reimbursement, etc., provided by the employer does not exceed $15 a month ($180 a year). The value of all such transit benefits (including any discounts on passes) furnished to the same individual are aggregated for purposes of determining whether the $15 limit has been exceeded.

j. Transitional rules for treatment of certain reductions in tuition

Prior Law

DEFRA provided an exclusion for qualified tuition reductions provided to an employee of an educational institution for education below the graduate level (Code sec. 117(d)). Also, the tuition reduction may be provided for the education of the spouse or a dependent child of the employee.

The tuition reduction exclusion is not available to officers, owners, or highly compensated employees if the plan discriminates in favor of such employees.

Explanation of Provision

Under the Act, for purposes of testing whether a tuition reduction program is nondiscriminatory, a special rule applies to certain plans. Under this special rule, a plan is treated as nondiscriminatory if (1) the plan meets the nondiscrimination requirement (as amended by the Act) on the day on which eligibility to participate in the plan closed, (2) at all times thereafter, the tuition reductions available under the plan are available on substantially the same terms to all employees eligible to participate in the plan, and (3) the eligibility to participate in the plan closed on June 30, 1972, June 30, 1974, or December 31, 1975. Of course, the conditions for eligibility cannot be altered after the eligibility closed. For purposes of testing plans not subject to this special rule, employees covered by plans subject to this special rule are disregarded in all respects.

In addition, in the case of all tuition reduction plans of an employer who maintains at least one plan to which the special rule applies, an employee not included in the plan is to be excluded from consideration if (1) such employee is included in a unit of employees covered by an agreement that the Secretary of the Treasury finds to be a collective bargaining agreement between employee representatives and one or more employers, and (2) there is evidence that such tuition reduction benefits were the subject of good faith bargaining. This provision is to apply for purposes of determining whether a plan satisfied the requirements for application of the special rule described above, except that for such purpose the provision is to be applied without regard to the lack of evidence that benefits under such plan were the subject of good faith bargaining.

In addition, the Act provides that any tuition reduction provided with respect to a full-time course of education furnished at the graduate level before July 1, 1988, is not included in gross income if (1) the reduction would not have been included in income under Treasury Regulations in effect on July 18, 1984, and (2) the reduction is provided with respect to a student who was accepted for admission to such course of education before July 1, 1984, and began the course of education before June 30, 1985.

5. Employee Stock Ownership Plans (ESOPs)

a. Sales of stock to employee stock ownership plans or certain cooperatives (sec. 1854(a) of the Act, secs. 1042, 4978, and new secs. 409(n) and 4979A of the Code)

Prior Law

In general

Under prior and present law, a taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an employee stock ownership plan (ESOP) or to an eligible worker-owned cooperative (EWOC) to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period. To be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an ESOP or EWOC; (2) the ESOP or EWOC must own, immediately after the sale, at least 30 percent of the total value of the employer securities then outstanding; (3) the ESOP or EWOC must preclude allocation of assets attributable to qualified securities to certain individuals; and (4) the taxpayer must provide certain information to the Secretary of the Treasury.

Qualified securities; qualified replacement property

For purposes of this provision under prior law, qualified securities were defined as employer securities that (1) were issued by a domestic operating corporation that had no readily tradable securities outstanding, (2) had been held by the seller for more than one year, and (3) had not been received by the seller as a distribution from a qualified plan or as a transfer pursuant to an option or similar right to acquire stock granted to an employee by an employer (other than stock acquired for full consideration).

Qualified replacement property (which included both debt and equity instruments, as defined in sec. 165(g)(2)) consisted of securities issued by another domestic corporation that did not, for the corporation's taxable year in which such securities were acquired by the taxpayer seeking nonrecognition treatment, have passive investment income (within the meaning of sec. 1362(d)(3)(D)) exceeding 25 percent of such corporation's gross receipts for that taxable year.

Exclusive benefit

Nonrecognition treatment was not available if assets attributable to qualified securities involved in a nonrecognition transaction accrued directly or indirectly for the benefit of (1) the taxpayer involved in the nonrecognition transaction, (2) any member of the taxpayer's family (within the meaning of sec. 267(b)), or (3) any other person who owned (after application of the sec. 318 attribution rules) more than 25 percent in value of any class of any outstanding employer securities.

If, within the period of the applicable statute of limitations, assets attributable to qualified securities involved in a nonrecognition transaction accrued directly or indirectly for the benefit of an individual in one of these three categories, the gain realized on the sale of the qualified securities to the ESOP or EWOC was recognized.

Although compliance with the restriction on the allocation of qualified securities was a condition of nonrecognition treatment, it was not a plan qualification requirement under prior law.

Election and notice requirement

The taxpayer seeking nonrecognition treatment was required to file with the Secretary of the Treasury (1) a written election to claim nonrecognition treatment, and (2) a verified written statement from the employer whose employees participate in the ESOP or an authorized officer of the EWOC consenting to the excise tax under section 4978. The written election claiming nonrecognition treatment, as prescribed by the Secretary of the Treasury, was required to be filed not later than the due date of the seller's income tax return for the seller's taxable year in which the sale occurred.

Under Treasury regulations, as part of the written election, the taxpayer was required to file a statement of purchase containing certain information regarding the qualified replacement property. The regulations provided that the statement of purchase was required to be notarized within 30 days after the purchase.[4]

Disposition of qualified replacement property

In general, prior law provided that the basis of the taxpayer in qualified replacement property was reduced by an amount not greater than the amount of gain realized on the sale of qualified securities to the employee organization which was not recognized pursuant to the election provided by the provision. The gain was to be recognized upon disposition of the qualified replacement property. However, prior law did not clarify the impact of any other rules that otherwise might permit nonrecognition treatment upon a direct or indirect disposition of the qualified replacement property.

Explanation of Provisions

Qualified securities; qualified replacement property

The Act makes several clarifying changes to the definition of qualified securities and qualified replacement property.

With respect to qualified securities, the Act makes it clear that stock of a corporation with no readily tradable stock outstanding may be eligible for nonrecognition treatment whether or not the corporation or any member of the controlled group has outstanding any readily tradable debt securities. The Act also clarifies that the nonrecognition provision applies only if the gain on the sale would otherwise have been long-term capital gain.[5] For example, the sale of securities that had been held for less than 6 months, and the sale of securities which otherwise would be treated as ordinary income (e.g., by reason of the collapsible corporation provisions) will be ineligible for nonrecognition treatment under this provision.

[4] See, generally, Temp. Treas. Reg. sec. 1.1042-1T.

[5] The current long-term capital gain holding period is 6 months; it will revert to 1 year effective with respect to property acquired after December 31, 1987.

With respect to qualified replacement property, the Act makes it clear that securities issued by a government or political subdivision may not be treated as replacement property.

Qualified replacement property is limited under the Act to securities issued by a domestic operating corporation other than the corporation that issued the securities involved in the nonrecognition transaction (or a member of the same controlled group of corporations). The Act generally defines an operating corporation as a corporation more than 50 percent of the assets of which were, at the time the securities were purchased or before the close of the replacement period, used in the active conduct of a trade or business. The Act provides that a financial institution (as defined in secs. 581 or 593) or insurance company is considered an operating corporation even though the institution does not meet this 50-percent test.

If (1) the corporation issuing the security owns stock representing control of one or more other corporations; (2) one or more other corporations own stock representing control of the corporation issuing the security; or (3) both (1) and (2), then all such corporations will be treated as one corporation for purposes of determining whether the security is qualified replacement property, for example, for purposes of determining whether the corporation is a domestic operating corporation and whether the corporation that issued the qualified replacement property also issued the qualified securities. For purposes of this provision, control means control within the meaning of section 304(c), except that qualified replacement property of the electing taxpayer attributable to that sale is disregarded. Thus, the stock of a start-up company will constitute qualified replacement property, notwithstanding the fact that the start-up company and the corporation that issued the securities involved in the nonrecognition transaction are treated as the same corporation under section 304(c).

The Act clarifies that, in determining whether an insurance company has passive investment income in excess of 25 percent of its gross receipts, dividends, interest, and gains derived from the investments made by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business and which are received from a person other than a related person are not taken into account.[6]

The Act clarifies that, in the case of the death of an individual who sold qualified securities to an ESOP, the executor of the individual's estate may invest the proceeds (within the replacement period) in qualified replacement property pursuant to an election under section 1042. The executor similarly could designate as qualified replacement property any property acquired by the decedent for which a statement of purchase has not been filed. The estate's basis in the qualified replacement property is to be determined under the general principles applicable under section 1042. A beneficiary who receives the qualified replacement property from the estate has a basis in the property equal to that of the executor's in

[6] The Act accomplished this result by providing a cross-reference to sec. 954(c)(3) of the Internal Revenue Code of 1954, which section has been repealed by the Act. Accordingly, a technical correction may be needed so that the statute reflects the intent of the provision.

the property, rather than the fair market value of the property on the date that the beneficiary acquires it.

Further, the Act provides an extended replacement period for sellers who had acquired replacement property that, pursuant to the Act, will no longer be considered qualified replacement property. Under the Act, if a security was acquired by a taxpayer prior to September 27, 1985, and such security no longer constitutes qualified replacement property, the period of time for the purchase of qualified replacement property is extended to December 31, 1986. Of course, this extension does not increase the amount of gain for which nonrecognition treatment may be claimed.

Thirty-percent test

Under the Act, it is clarified that the ESOP or EWOC must hold, immediately after the sale, at least 30 percent of the total number of shares of all classes of stock (other than preferred stock described in section 1504(a)(4)), or (2) 30 percent of the total value of all outstanding stock of the corporation that issued the qualified securities (other than preferred stock described in sec. 1504(a)(4)). With respect to sales after May 6, 1986, 30-percent ownership by the employee organization is to be tested after application of the ownership attribution rules of section 318(a)(4).

With respect to sales of stock after July 18, 1984, and before the date of enactment of the Act, the 30-percent requirement is satisfied if, immediately after the sale, the ESOP or EWOC owned at least 30 percent of the number or value of employer securities outstanding at the time of sale. For purposes of this special rule, as well as the general rules, the ownership attribution rules of section 318(a)(4) apply to sales occurring after May 6, 1986.

Exclusive benefit

The Act makes several clarifying changes to the requirement that the employee organization be maintained for the exclusive benefit of employees. First, the Act clarifies that no portion of the assets attributable to qualified securities with respect to which a nonrecognition election is made may be allocated during the nonallocation period to (1) a taxpayer seeking nonrecognition treatment, (2) any person who is related to that taxpayer in one of the ways described in section 267(b), or (3) any other person who owns (after application of the attribution rules of section 318(a)) more than 25 percent (by number) of (a) any class of outstanding stock of the corporation (or certain related corporations) that issued such qualified securities, or (b) any class of stock of certain related corporations.

The nonallocation period is the period beginning on the date of the sale and ending on the date that is 10 years after the later of (1) the date of sale or (2) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale.[7]

In addition, the Act makes it clear that this restriction applies to prohibit any direct or indirect accrual of benefits under any qualified plan of an employer or an allocation of assets attributable to

[7] A technical correction may be needed so that the statute reflects this intent.

the qualified securities involved in the nonrecognition transaction. Thus, for example, an ESOP in which the taxpayer seeking nonrecognition treatment participates could not allocate to the taxpayer's account any assets attributable to the securities involved in the nonrecognition transaction. Nor could the employer make an allocation of other assets to the taxpayer under the ESOP or any other qualified plan of the employer without making additional allocations of securities other than those involved in the nonrecognition transaction to other participants sufficient separately to satisfy the nondiscrimination requirements of section 401(a).

The restriction is not intended to apply to amounts which are provided to the individual outside of a qualified plan, for example, through a nonqualified deferred compensation agreement.

The Act clarifies that an individual is to be treated as a 25-percent shareholder only if the individual is a 25-percent shareholder (1) at any time during the one-year period ending on the date of the sale of section 1042 securities to an ESOP, or (2) on the dates as of which any section 1042 securities sold to the ESOP are allocated. In the case of an individual who satisfies the condition described at (1), the individual will continue to be treated as a 25-percent shareholder until all of the qualified securities acquired pursuant to the sale are allocated. In the case of an individual who does not satisfy the condition described at (1), but meets the condition described at (2), the individual will be treated as a 25-percent shareholder only with respect to those section 1042 securities allocated as of the date or dates that the individual is a 25-percent shareholder.

The Act also provides that, for purposes of determining whether an individual owns more than 25 percent of the outstanding stock of the corporation which issued the employer securities, all allocated securities held by an ESOP are treated as securities owned by the ESOP participant to whom the securities are allocated and are also treated as outstanding securities.

The Act also provides that individuals who would be ineligible to receive an allocation of qualified securities *solely* because they are lineal descendants of the taxpayer may receive an allocation of the section 1042 securities provided that the total amount of such securities allocated to all such lineal descendants is not more than 5 percent of all section 1042 securities attributable to a sale to the plan by any person related to such descendants (within the meaning of sec. 267(c)(4)). For purposes of determining whether lineal descendants of a selling taxpayer have been allocated more than 5 percent of the employer securities to which section 1042 applies (or amounts in lieu thereof), all employer securities sold to the ESOP by the taxpayer which are eligible for nonrecognition treatment are taken into account.

The provisions are generally effective with respect to sales of securities after October 22, 1986. However, for purposes of determining whether an individual is a 25-percent shareholder with respect to sales occurring before October 22, 1986, in taxable years beginning after July 18, 1984, all allocated securities held by an ESOP may be treated as outstanding with respect to the individual if securities allocated to the individual under the ESOP are treated as securities owned by the individual.[8]

Disqualification; excise tax

The Act provides that an ESOP that acquires section 1042 securities is required to provide that the restriction on the allocation of securities to the sellers, family members, and 25-percent shareholders (sec. 409(n)) will be satisfied. The sanction for failure to comply with this requirement is disqualification of the plan with respect to those participants who received prohibited allocations. Thus, failure to comply results in income inclusion for those participants of the value of their prohibited allocations on the date of such allocations.

The Act also provides that, if there is a prohibited allocation or accrual by an ESOP or an EWOC of employer securities acquired in a section 1042 transaction, then a 50-percent excise tax is imposed on the amount involved in the prohibited allocation. This excise tax is to be paid by the employer who maintains the ESOP or by the EWOC.

These provisions are effective with respect to sales of securities after October 22, 1986.

Eligible taxpayers

Generally, effective for sales after March 28, 1985, the Act limits the class of taxpayers eligible to elect nonrecognition treatment under this provision by making the election unavailable to any subchapter C corporation. However, a subchapter C corporation may elect nonrecognition treatment with respect to certain sales made before July 1, 1985, provided the sales otherwise satisfy the requirements of this provision and are made pursuant to a binding contract in effect on March 28, 1985, and at all times thereafter.

Election and notice

The Act clarifies that a taxpayer making a section 1042 election is not required to obtain a notarized "statement of purchase" describing the qualified replacement property until 90 days after the later of (1) the sale of the qualified securities, or (2) the purchase of the qualified replacement property. Congress intended that the Secretary of the Treasury is to provide forms for the election of nonrecognition treatment under section 1042 and for the "statement of purchase" describing the qualified replacement property. It is also intended that anyone electing nonrecognition treatment under section 1042 would be required to use such forms for sales occurring 180 days after the publication of such forms.

Basis adjustment

The Act provides that market discount (as defined in sec. 1278(a)(2)(A)(ii)) is not created by reason of the basis adjustment resulting from a qualified sale to an ESOP or EWOC.

[8] A technical correction may be needed so that the statute reflects this intent.

Disposition of qualified replacement property

The Act also clarifies the coordination of the provision's requirement that gain be recognized upon disposition of any qualified replacement property with other rules providing nonrecognition treatment. Effective for dispositions made after the date of enactment, the Act overrides all other provisions permitting nonrecognition and requires that gain realized upon the disposition of qualified replacement property be recognized at that time. The Act exempts from the rule that gain is to be recognized upon the disposition of qualified replacement property: (1) dispositions at death; (2) dispositions by gift; (3) certain exchanges required in the event of a reorganization provided the corporation involved in the reorganization is not controlled by the taxpayer holding qualified replacement property; and (4) subsequent sales of the qualified replacement property to an ESOP, pursuant to a transaction governed by section 1042.

The amount of gain required to be recognized upon the disposition of qualified replacement property is limited to the amount not recognized pursuant to the election provided by this provision by reason of the acquisition of such replacement property. Any gain in excess of that amount continues to be eligible for any otherwise applicable nonrecognition treatment.

To ensure that this rule is not avoided through the use of controlled corporations, the Act provides special rules for corporations controlled by the taxpayer seeking nonrecognition treatment. If the taxpayer owns stock representing control (within the meaning of sec. 304(c)) of the corporation issuing the qualified replacement property, the taxpayer shall be treated as having disposed of such qualified replacement property when the corporation disposes of a substantial portion of its assets other than in the ordinary course of its trade or business.

b. Deduction for dividends paid on ESOP stock (sec. 1854(b) of the Act and sec. 404(k) of the Code)

Prior Law

Prior law permitted an employer to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that was held by an ESOP (including a tax-credit ESOP), but only to the extent such dividends were actually paid out currently to plan participants. The employer could claim a deduction for dividends for the employer's taxable year when paid to the extent that the dividends (1) were, in accordance with the plan provisions, paid in cash directly to the participants, or (2) were paid to the plan and subsequently distributed to the participants in cash no later than 90 days after the close of the plan year in which paid.

Under present and prior law, for income tax purposes, dividends distributed under an ESOP, whether paid directly to participants pursuant to plan provisions or paid to the plan and redistributed to participants, generally are treated as plan distributions. Accordingly, such dividends do not qualify for the partial exclusion from income otherwise permitted under section 116.

Explanation of Provision

The Act clarifies that a corporation will be allowed a deduction for dividends paid on stock held by an ESOP whether such dividends are passed through to beneficiaries of plan participants or to the plan participants themselves. In addition, the Act makes it clear that employer deductions for dividends paid on employer stock held by an ESOP are to be permitted only in the year in which the dividend is paid or distributed to the participant or beneficiary. Thus, where the employer pays such dividends directly to participants in accordance with plan provisions, a deduction would be permitted in the year paid. However, where the employer pays such dividends to the ESOP for redistribution to participants no later than 90 days after the close of the plan year, a deduction would be permitted in the employer's taxable year in which the dividend is distributed from the ESOP to the participants.

However, the provision is inapplicable to dividends paid before January 1, 1986, if the employer deducted such dividends in the taxable year they were paid to the ESOP and filed a return for that taxable year before the date of enactment.

The Act clarifies that, although the dividends for which the Act allows a deduction are generally to be treated as distributions under the plan, they are to be fully taxable and treated as a separate contract under the plan. Thus, these distributions are not to be treated as distributions of net employee contributions. The provision is inapplicable to dividends paid before January 1, 1986, which a taxpayer treated as the nontaxable return of employee contributions for purposes of a return filed before the date of enactment.

The Act also makes it clear that current distributions of dividends paid on employer stock allocated to a participant's account under an ESOP will not be considered disqualifying distributions.

Further, the Act empowers the Treasury to disallow deductions for dividends paid on stock held by an ESOP, if the dividend constitutes, in substance, the evasion of taxation. The deduction is available only with respect to reasonable dividends. Thus, for example, if amounts paid by an employer and treated for tax purposes as 404(k) dividends are the payment of unreasonable compensation, such payments would not qualify for treatment as section 404(k) dividends.

c. Partial exclusion of interest earned on ESOP loans (sec. 1854(c) of the Act and sec. 133 of the Code)

Prior Law

Under present and prior law, a bank, an insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan.

Under present and prior law, a securities acquisition loan means any loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of sec. 409(l)) for the plan. Under prior law, a securities acquisition loan did not include any loan between corporations that are members of the same controlled group of corporations.

Temporary regulations issued by the Treasury provide that a loan made to a corporation sponsoring an ESOP qualifies as a securities acquisition loan only to the extent that, and for the period which, the proceeds are (1) loaned to the corporation's ESOP under a loan that qualifies as an exempt loan under section 4975 and that has terms "substantially similar" to the terms of the loan between the commercial lender and the sponsoring organization and (2) used to acquire employer securities for the ESOP.

Under the temporary regulations, the terms of the loan from the commercial lender to the sponsoring corporation and the terms of the loan from such corporation to the ESOP are treated as substantially similar only if the timing and rate at which employer securities would be released from encumbrance if the loan from the commercial lender were the exempt loan under section 4975 are substantially similar to the timing and rate at which employer securities are actually released from encumbrance in accordance with section 4975. Thus, the regulations match the timing of the repayment of the loan to the corporation with the allocation of shares in the ESOP, and provide that allocation of shares occurs as rapidly as repayment of the loan to the corporation.[9]

Explanation of Provision

The Act (1) clarifies the interaction of the partial interest exclusion with other provisions affecting tax-exempt income, and (2) clarifies the meaning of the term "securities acquisition loan."

Interaction with other provisions.—The Act makes it clear that for purposes of section 291(e), relating to certain tax preference items, (1) interest on an obligation eligible for the partial exclusion of section 133 will not be treated as exempt from tax, and (2) in determining the interest allocable to indebtedness on tax-exempt obligations, obligations eligible for the partial exclusion will not be taken into account in calculating the taxpayer's average adjusted basis for all assets.

In addition, the Act clarifies the coordination of the partial exclusion with the installment payment provisions (sec. 483) and the original issue discount rules (secs. 1271 through 1275). The Act makes it clear that, in testing the adequacy of the stated interest rate for purposes of section 483 and sections 1271 through 1275, the applicable Federal rate will be adjusted as appropriate to reflect the partial interest exclusion. In addition, the Act clarifies that the below market interest rate rules (sec. 7872) do not apply to a loan between a sponsoring employer and an ESOP, provided that the interest rate payable on such loan is no less than the interest rate payable by the employer on a corresponding section 133 loan.

Securities acquisition loan.—The Act makes several changes to the definition of "securities acquisition loan." The Act (1) clarifies the definition of securities acquisition loan in the case of a loan to a sponsoring corporation with a corresponding loan from the corporation to the ESOP ("back-to-back" loans), (2) includes in the defini-

[9] See, generally, Temp. Treas. Reg. sec. 1.133-1T.

tion of securities acquisition loan a loan to a corporation if, within 30 days of the date of the loan, employer securities are transferred to the plan in an amount equal to the proceeds of such loan and such securities are allocable to participant accounts within 1 year of the date of such loan ("immediate allocation loan"); (3) clarifies that the refinancing of a loan to an ESOP can qualify as a securities acquisition loan; and (4) clarifies the definition of securities acquisition loan with respect to loans within a controlled group of corporations. Items (1) and (4) are in the technical corrections portion of the Act.[10]

The Act clarifies the definition of a securities acquisition loan in the case of a loan to a corporation. The Act provides that a loan to a sponsoring corporation will qualify as a securities acquisition loan if the terms of such loan are substantially similar to the terms of the corresponding exempt loan from the corporation to the ESOP. In addition, the Act provides that, if the terms of the 2 loans are not substantially similar, the loan to the sponsoring corporation will still qualify as a securities acquisition loan if (1) the corresponding loan to the ESOP provides for more rapid payment of principal or interest than the loan to the sponsoring corporation; (2) the allocations of stock within the ESOP attributable to the difference in payment schedules do not result in discrimination in favor of highly compensated employees; and (3) the total commitment period of the loan to the sponsoring corporation is not more than 7 years.

The 7-year limitation applies to the total commitment period. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by one or more lenders in a series of shorter maturity loans, each of which (other than the first) is used to repay the preceding loan. If the total commitment period of the loan is extended beyond 7 years, then the partial exclusion will continue to apply for the first 7 years of the loan.[11]

The Act also clarifies that, although a securities acquisition loan may not originate with any member of the controlled group, it may be held by a member of the controlled group. However, during any such time that a securities acquisition loan is held by a member of the controlled group, any interest received with respect to such loan during such period will not qualify for the exclusion provided under section 133.

The provisions relating to the availability of the section 133 interest exclusion in the case of back-to-back loans and controlled group loans are effective as if included in the Deficit Reduction Act of 1984, i.e., they are effective with respect to loans made after July 18, 1984, and used to acquire employer securities after such date.

[10] For further discussion of the changes made to the definition of securities acquisition loan, see *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), in Title XI., Part G.

[11] A technical correction may be needed so that the statute reflects this intent.

d. Payment of estate tax liability by ESOP (sec. 1854(d) of the Act and sec. 2210 of the Code)

Prior Law

Under prior law, if qualified employer securities were (1) acquired from a decedent by an ESOP or an eligible worker-owned cooperative (EWOC), (2) passed from a decedent to an ESOP or EWOC, or (3) were transferred by the decedent's executor to an ESOP or EWOC, then the executor of the decedent's estate generally was relieved of the estate tax liability to the extent the ESOP or EWOC is required to pay the liability.

No executor was relieved of estate tax liability under this provision with respect to securities transferred to an ESOP unless the employer whose employees participate in the ESOP guaranteed, by surety bond or other means as required by the Secretary of the Treasury, the payment of any estate tax or interest.

To the extent that (1) the decedent's estate was otherwise eligible to make deferred payments of estate taxes pursuant to section 6166 with respect to the decedent's interest in qualified employer securities, and (2) the executor elected to make payments pursuant to that section, the plan administrator of the ESOP or an authorized officer of the EWOC also could elect to pay any estate taxes attributable to the qualified employer securities transferred to the ESOP or EWOC in installments pursuant to that section. The usual rules (sec. 6166) applied to determine ongoing eligibility for deferral. Thus, for example, disposition of the qualifying securities held by the estate and employee organization could trigger acceleration of any remaining unpaid tax.

Explanation of Provision

The Act makes several changes to clarify the applicability of these provisions and the coordination with the provisions governing the installment payment of estate taxes under section 6166. First, the Act makes it clear that, with respect to the estates of individuals dying after September 27, 1985, only executors of those estates eligible to make deferred payments of estate taxes may be relieved of estate tax liability under this provision. In addition, under the Act, the transfer of employer securities to an ESOP or to an eligible EWOC will not be treated as a disposition or withdrawal which triggers acceleration of the remaining unpaid tax.

The Act makes it clear that, after the transfer, the ongoing eligibility of the estate and the ESOP or EWOC to make installment payments applicable to their respective interests is to be tested separately. Thus, with respect to the estate's remaining interest (if any), cumulative dispositions and withdrawals of amounts up to 50 percent of the estate's remaining interest would be permitted without requiring acceleration of the remaining unpaid tax. Similarly, with respect to an ESOP or EWOC cumulative dispositions and withdrawals of up to 50 percent of the interest transferred to the ESOP or EWOC would be permitted without requiring acceleration. In addition, under the Act, a distribution made by an ESOP to participants on account of death, retirement after attainment of age 59½, disability, or any separation from service resulting in a one-year break in service will not be treated as a disposition requiring acceleration of any unpaid tax and will not be taken into account in determining whether any subsequent disposition triggers acceleration.

The Act also makes it clear that no executor will be relieved of estate tax liability with respect to employer securities transferred to an eligible EWOC unless the EWOC guarantees the payment of any estate tax or interest by surety bond or other means as required by the Secretary of the Treasury.

e. Voting rights (sec. 1854(f) of the Act and sec. 409 of the Code)

Prior Law

Under prior and present law, a tax credit ESOP (sec. 409), a leveraged ESOP and, in some circumstances, a defined contribution plan (sec. 401(a)(22)) are required to meet certain voting rights requirements with respect to employer securities held by the plan. Under prior law, if the employer does not have a registration-type class of securities, the plan is required to permit each participant to direct the plan as to the manner in which voting rights under employer securities which are allocated to the account of the participant are to be exercised with respect to corporate matters that (by law or charter) must be decided by more than a majority vote of the outstanding common shares voted.

Explanation of Provision

The Act modifies the voting rights requirements applicable to an ESOP where the employer does not have a registration-type class of securities by (1) mandating that voting rights be passed through to participants with respect to certain enumerated issues; and (2) accommodating the one person-one vote philosophy of certain types of ESOPs and EWOCs.

First, the Act requires, with respect to certain issues specified in the Act, that a plan permit participants to direct the vote under employer securities allocated to the participants' accounts, regardless of whether the issue was required (by law or charter) to be decided by more than a majority vote of the outstanding common shares voted. The issues on which the pass-through of voting rights is required are merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all of the assets of a trade or business of the corporation and, to the extent provided by regulations, other similar issues.

Second, the Act permits the trustee of an ESOP or EWOC, the by-laws or terms of which require that the interests in the ESOP or EWOC be governed on a one vote per participant basis, to vote the employer securities in a manner that reflects the one man-one vote philosophy. Under this alternative, each ESOP or EWOC participant is entitled to cast one vote on an issue. The trustee would then be required to vote the employer securities held by the ESOP or EWOC in proportion to the results of the votes cast on the issue by the participants. The provision is permissive, that is, an ESOP or EWOC is not required to provide that participants vote on this basis.

The requirements relating to one vote per participant are effective on the date of enactment. The requirements relating to pass-through voting are effective after December 31, 1986, for securities acquired after December 31, 1979.

f. Net unrealized appreciation (sec. 1854(f)(2) of the Act and sec. 402 of the Code)

Prior Law

Under prior law, in the case of a distribution of securities of the employer from a qualified plan, an employee was permitted to exclude from income the net unrealized appreciation (NUA) on such securities attributable to employee contributions. In addition, if the distribution qualified as a lump-sum distribution, the employee was generally permitted to exclude from income the NUA on such securities, regardless of whether appreciation was attributable to employer or employee contributions (secs. 402(a)(1) and 402(e)(4)(J)). Upon disposition of the stock in a taxable transaction, the participant was taxed on the previously excluded NUA at capital gains rates. NUA was generally measured as the difference between the fair market value at distribution and the basis of the securities.

In the case of an acquisition of one corporation by another, shares of the company held by a plan sponsored by the company are sometimes exchanged for shares of the acquiring company in a transaction that generally would be taxable if the stock were not held by a qualified plan. Alternatively, the plan may exchange shares of the target company for cash or other property that the plan later reinvests in qualifying securities of the employer. Under prior law, the IRS took the position that in a case in which securities of the employer held by a plan were exchanged for cash or other securities of the employer in a transaction that would be taxable if the securities were held by a taxable entity, the plan's basis in such securities received pursuant to the exchange (or purchased with cash or other property received pursuant to the exchange) was generally increased or "stepped up" to reflect the fair market value of the securities, cash, or property used to acquire new securities. Because the newly acquired securities had a "stepped-up" basis, rather than the same basis as the securities that were disposed of in the exchange, the previously accumulated NUA on the old securities was eliminated.

Explanation of Provision

The Act provides that if, for example, pursuant to a tender offer, a plan fiduciary, in the exercise of its fiduciary duties, exchanges previously acquired securities of the employer for other securities of the employer, the plan will have the same basis in the acquired securities as it had in the securities exchanged for the acquired securities. Similarly, if a plan fiduciary, in the exercise of its fiduciary duties, disposes of such securities for cash because the securities are called, because the trustee tenders such securities in response to a tender offer, or because such disposition is required by ERISA or the Internal Revenue Code, and the proceeds are reinvested in securities of the employer within a 90-day period (unless the Secretary provides an extension of the 90-day period) the plan will have the same basis in such securities purchased with the cash proceeds as the plan had in the securities sold. The provision is effective with respect to any transaction occurring after December 31, 1984; however, in the case of a transaction occurring before the date of enactment of the Act, the reinvestment period does not end before the earlier of (1) one year after the date of the transaction or (2) 180 days after the date of enactment.

g. Right to demand employer securities; put option (sec. 1854(g)(3) of the Act and sec. 409 of the Code)

Prior law

Under prior law, an employee stock ownership plan (ESOP) generally is required to provide that plan participants have the right to receive their benefits in the form of employer securities. However, this requirement does not apply in the case of an employer whose charter or by laws restrict the ownership of substantially all outstanding employer securities to employees of a trust described in section 401(a), if the plan provides that plan participants have the right to receive distributions in cash.

Explanation of Provisions

Effective as of the date of enactment, the Act permits a plan sponsored by a corporation whose by-laws or charter restrict the ownership of substantially all outstanding employer securities to employees or a trust described in section 401(a) to distribute employer securities in certain cases. If such a plan does distribute employer securities, the distribution requirements and put option requirements generally applicable to ESOPs (except for the requirement that the employee has a right to demand that the distribution be paid in employer securities) will apply to the distribution.

6. Miscellaneous Provisions

a. Incentive stock option provision (sec. 1855(a) of the Act and secs. 57 and 422A of the Code)

Prior Law

The 1984 Act clarified that the fair market value of stock, for purposes of applying the incentive stock options provisions, was determined without regard to lapse restrictions.

The 1984 Act applied, for purposes of the minimum tax, to options exercised after March 20, 1984. Transitional relief was provided for certain options exercised on or before December 31, 1984.

Explanation of Provision

The Act clarifies that, under the transitional rule, the amendment to the minimum tax provision relating to incentive stock options (sec. 57(a)(10)) will not apply to options exercised before January 1, 1985, if the option was granted pursuant to a plan adopted or corporate action taken by the board of directors of the grantor corporation before May 15, 1984.

b. Time for making certain section 83(b) elections (secs. 1855(b) of the Act and sec. 556 of the 1984 Act)

Prior Law

The 1984 Act extended the time for making certain section 83(b) elections where property was transferred to the taxpayer after June 30, 1976 and before November 18, 1982, where the taxpayer paid fair market value (determined without regard to certain restrictions).

Explanation of Provision

The Act extends the provision of that 1984 Act to transfers made before July 1, 1976.

F. Technical Corrections to the Tax-Exempt Bond Provisions

1. Mortgage revenue bond and mortgage credit certificate provisions (secs. 1861–1863 of the Act and secs. 25 and 103A of the Code)

Prior Law

Mortgage revenue bonds

The 1984 Act extends the tax-exemption for qualified mortgage bonds for four years, for bonds issued after December 31, 1983, and before January 1, 1988. These bonds generally are subject to the same restrictions as applied to such bonds issued before January 1, 1984.

The 1984 Act restricts the issuance of qualified veterans' mortgage bonds by (1) limiting the veterans eligible for loans financed with these bonds, and (2) imposing State volume limitations based on pre-1984 issuance of the bonds. The 1984 Act further directs the Federal Financing Bank to make cash flow loans to the Oregon Department of Veterans' Affairs to offset lower than anticipated prepayments on loans funded with specified veterans' mortgage bonds.

Mortgage credit certificates

As an alternative to qualified mortgage bonds, the Act permits States to elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs generally are subject to the same eligibility restrictions as qualified mortgage bonds.

Explanation of Provisions

Mortgage revenue bonds

The Act clarifies that, in certain cases, the Treasury Department may grant extensions of time for publishing annual policy statements that issuers of qualified mortgage bonds are required to make. These statements must explain measures taken by the issuers to comply with the Congressional objective of providing housing for lower-income persons.

The Act further clarifies that the requirement of this annual policy statement and the requirements that (1) certain information be reported to Treasury with respect to each bond issue and (2) a State official certify compliance with Code restrictions are treated as satisfied if the issuer in good faith attempted to meet the requirement and the failure to meet the requirement is due to inadvertent error.

The Act clarifies that veterans eligible for loans financed by qualified veterans' mortgage bonds must apply for the financing

before the later of (1) 30 years after leaving active service, or (2) January 31, 1985 (rather than January 1, 1985).

The Act provides that the Oregon Department of Veterans' Affairs (Oregon) may advance refund up to $300 million of qualified veterans' mortgage bonds and expands the list of specified bonds that may be advance refunded. (Advance refundings of mortgage subsidy bonds otherwise are prohibited.) The advance refunding is in lieu of authority included in the Act permitting that State agency to receive cash flow loans not exceeding $300 million at any time from the Federal Financing Bank (FFB). This provision is effective on the date of enactment, and does not affect the status of cash flow loans made under an interim financing agreement entered into between Oregon and the FFB before that date.

Mortgage credit certificates

Issuers of qualified mortgage bonds must satisfy information reporting requirements, must certify that the bonds meet the volume limitation requirement of the Code, and must publish annual policy statements demonstrating that their programs satisfy Congress' objective in authorizing issuance of tax-exempt bonds for this purpose. The Act clarifies that these requirements also apply with respect to MCCs.

The Act clarifies that good faith errors in MCC program administration may be corrected without invalidating all MCCs issued under the program. The Act further clarifies the method for determining the amount of excess credit that may be carried forward for up to three years by a taxpayer.

2. Private activity bond provisions (secs. 1864–1873 of the Act and sec. 103 of the Code)

Prior Law

Volume limitations

Private activity bonds generally are subject to State volume limitations. The limitations apply to most industrial development bonds (IDBs) and to student loan bonds issued within the State. Certain bonds issued to finance governmentally owned airports, docks, wharves, convention or trade show facilities, and mass commuting facilities are not subject to these volume limitations.

The 1984 Act provides a statutory formula for allocating each State's volume limitation among issuers within the State. This Federal formula may be overridden by State statute, or by gubernatorial proclamation on an interim basis. Issuers may elect to carry forward bond authority for up to three years (six years in certain cases) for certain, specifically identified projects.

Prohibition on Federal guarantees of tax-exempt bonds

The 1984 Act provides that interest on bonds, repayment of which is directly or indirectly guaranteed (in whole or in part) by the Federal Government, is taxable. The underlying economic substance of a transaction determines whether repayment of bonds is Federally guaranteed. Thus, depending on the facts and circumstances of each case, a Federal guarantee may arise from contracts providing for purchase of the output of a facility by the Federal Government, from leases of property to the Federal Government, and from other similar arrangements, as well as from a direct agreement to repay the bonds.

Additional arbitrage restrictions for most IDBs and for student loan bonds

In the case of IDBs (other than IDBs for multifamily residential rental property), the Act limits the amount of bond proceeds that may be invested in obligations not related to the purpose of the borrowing and requires rebates to the Federal Government of arbitrage profits in certain cases. The 1984 Act also directs the Treasury Department to prescribe regulations extending additional arbitrage restrictions similar to those for most IDBs to student loan bonds.

$40 million limit on small-issue IDBs

The 1984 Act prohibits tax-exemption for small-issue IDBs if a beneficiary of the IDBs is a beneficiary of more than $40 million of all types of tax-exempt bonds. Bonds used to redeem other bonds do not count towards the $40 million limit; however, such refunding bonds may not be issued if a beneficiary of the bonds benefits from more than $40 million of outstanding bonds at the time of the refunding.

Private (consumer) loan bonds

The 1984 Act provides that interest on bonds generally is not tax-exempt if five percent or more of the proceeds is reasonably expected to be used, directly or indirectly, to make loans to nonexempt persons. Exceptions are provided for IDBs, qualified student loan bonds, mortgage revenue bonds, and for certain bonds used to finance assessments or taxes of general application for an essential governmental function.

As enacted in 1984, this restriction makes no distinction between bonds that are used to finance loans for businesses and bonds used to finance personal loans. For example, an issue may be in violation of this restriction if 5 percent or more, but no more than 25 percent, of the proceeds is used to provide financing that would be considered IDB-financing, but for the fact that bonds are not treated as IDBs if no more than 25 percent of the proceeds is used for a purpose described in section 103(b). Similarly, an obligation that would be an IDB except for the fact that the security interest test of section 103(b)(2)(B) is not satisfied may be in violation of this restriction.

Restriction on acquisition of existing facilities

The 1984 Act restricts tax-exempt financing for the acquisition of existing facilities to cases where an amount equal to at least 15 percent of the bonds is spent on rehabilitation of a building and associated equipment. In the case of structures other than buildings, the rehabilitation expenditures must equal or exceed the amount of bond financing.

Application of certain Internal Revenue Code requirements to bonds exempt from tax pursuant to other provisions of law

The 1984 Act provides that bonds issued pursuant to provisions of law other than the Internal Revenue Code must satisfy appropriate Code requirements as a condition of tax-exemption. Examples of these requirements are the Code restrictions on IDBs, the arbitrage rules, the prohibition on Federal guarantees of tax-exempt bonds, the State volume limitations, and the public approval and information reporting requirements.

Small-issue IDB principal user rule

Small-issue IDBs generally may not exceed $1 million per issue. If a special election is made, this limit is increased to $10 million, but all capital expenditures that principal users of the facility incur within a prescribed period with respect to facilities located in the same municipality (or county, if not in any municipality) are aggregated with the amount of the bonds in determining whether the $10 million limit is exceeded.

Effective dates

Section 631 of the 1984 Act provides effective dates for the various tax-exempt bond provisions for which (1) no separately stated effective dates are included as part of the section of the Act containing the substantive rule, or (2) no effective dates are provided by means of dates included within substantive rules identifying the bonds to which the rules apply. Transitional exceptions are provided with respect to many of the provisions for which the effective dates are provided in Act section 631. Additionally, special exceptions are provided in Act sections 631 and 632 for certain specifically described facilities.

Explanation of Provisions

Volume limitations

Facilities located outside a State.—The Act clarifies that each State's annual private activity bond volume limitation generally may be used only to finance facilities located within that State. Under this clarification, a State may allocate a portion of its volume limitation to financing for facilities located outside its boundaries only in the case of specified facilities, and only to the extent of the State's share of the use of those facilities.

Facilities located outside a State and to which a State may allocate a portion of its volume limitation include (1) otherwise eligible sewage and solid waste disposal facilities or facilities for the local furnishing of electric energy or gas (sec. 103(b)(4)(E)); (2) otherwise eligible facilities for furnishing of water (sec. 103(b)(4)(G)); and (3) qualified hydroelectric generating facilities (sec. 103(b)(4)(H)). This clarification does not affect the rule in Code section 103(o)(3) that qualified student loan bonds must be issued to finance loans both to (1) residents of the State issuing the bonds regardless of the location of the school the residents attend, and (2) students attending schools within the issuing jurisdiction, regardless of the State of their legal residence, since no facilities are financed with student loan bonds.

In the case of sewage and solid waste disposal facilities, the determination of a State's use of a facility is based on the percentage of the facility's total treatment provided to the State (and its residents). In the case of facilities for the local furnishing of electric energy and gas, facilities for the furnishing of water, and qualified hydroelectric generating facilities, the determination of use is based upon the share of the output of the facility received by the State (and its residents).

These clarifications generally are effective for bonds issued after the date of the Act's enactment. Under a special rule, a State may elect to apply this rule in the case of bonds issued before the date of enactment.

Certain facilities financed outside a State's volume limitation.—The Act clarifies that the determination of whether facilities forming a part of an airport, dock, wharf, mass commuting facility, or trade or convention center may be financed outside a State's volume limitation is to be made on a property-by-property basis rather than by reference to the entire airport or other excepted facility. Under the Act, all property to be financed pursuant to this exception must be owned by or on behalf of a governmental unit. Therefore, property financed with the so-called "insubstantial portion" of bond proceeds that otherwise could be used for a purpose other than the governmental purpose for which the bonds are issued also must be governmentally owned.

Designation of carryforward projects.—Congress wished to clarify statements included in the legislative history accompanying the 1984 Act concerning the designation of projects for which an election was made to carryforward annual private activity bond volume authority under prior law. That legislative history, in explaining the authority of the Treasury Department to require specific identification of all projects for which an issuer made a carryforward election, included a specific street address as information Treasury might require in the notice of election. (Temporary Treasury regulations on that provision required a specific address for all elections with respect to exempt-activity IDBs.)

Congress intended that, in the case of solid waste disposal facilities (described in former sec. 103(b)(4)(E)) that would process solid waste from all residents of the issuing governmental unit, Treasury will waive the requirement of a specific street address for elective carryforwards for projects involving such facilities. On the other hand, in the case of facilities such as air or water pollution control facilities, and other facilities financed with exempt-activity IDBs that were identified more specifically with a limited group of users or more than one of which might have been financed within the jurisdiction of the issuing governmental unit, a specific street address was appropriately required when the carryforward election was made.

Authority to allocate a State's volume limitation directly to issuing authorities other than governmental units.—The Act clarifies that a State may allocate its private activity bond volume limitation directly to issuing authorities within the State that are not governmental units as well as to such governmental units. This clarification applies to allocations pursuant to gubernatorial proclamations and also to allocations pursuant to State statutes.

Reporting requirement for allocations of volume limitations.—The Act clarifies the authority of the Treasury Department to require reports on allocations of State volume limitations as part of the presently required information reporting (sec. 103(l)).

Prohibition on Federal guarantees

The Act provides transitional relief for a convention center (Carbondale, Illinois) to be financed with bonds for which the Farmers Home Administration had authorized a Federal guarantee before enactment of the Act.

The Act also provides transitional exceptions for a limited amount of bonds for five solid waste disposal facilities. Bonds for these facilities are indirectly Federally guaranteed as a result of the anticipated purchase by the Federal Government under contract of more than an insignificant portion of the output of the facilities. Expenditures were made with respect to each facility before October 19, 1983.

Additional arbitrage restrictions for most IDBs and student loan bonds

The Act corrects a reference to a resource recovery project of Essex County, New Jersey, contained in a transitional exception to the additional arbitrage restrictions for most IDBs. Additionally, the Act clarifies the application of an exception for refundings of student loan bonds in the case of a series of refundings, and expands a transitional rule included in the Act for a Muskogee, Oklahoma project to include a limited exception from the arbitrage rebate rules for IDBs.

$40 million limit on small-issue IDBs

The Act permits small-issue IDBs to be refunded to reduce the interest rate on the borrowing even though a beneficiary of the bonds benefits from more than $40 million in tax-exempt financing. Small-issue IDBs may be refunded in such cases only if (1) the maturity of the refunded bonds is not extended; (2) the amount of the refunding bonds does not exceed the outstanding amount of the refunded bonds; (3) the interest rate on the refunding bonds is lower than the rate on the refunded bonds; and (4) the refunded bonds are redeemed no later than 30 days after issuance of the refunding bonds (i.e., called so that no interest accrues on the refunded bonds after such time).

Consumer loan bonds

The Act retitles consumer loan bonds "private loan bonds" to reflect the fact that, under that provision of the Act, all bonds issued to finance loans to nonexempt persons are subject to this restriction unless a specific exception is provided in the Code (e.g., the exceptions for IDBs, mortgage revenue bonds, qualified student loan bonds, and certain bonds to finance assessments or taxes of general application for an essential governmental function). This provision does not amend the substantive scope of the restriction, as enacted in 1984.

A transitional exception is provided for bonds issued before 1985 for the White Pine, Nevada power project, with respect to which indirect loans to nonexempt persons will be made through contracts providing the persons with a significant portion of the output of the facilities. Additional transitional exceptions are provided for (1) certain bonds for the Mead-Phoenix power project for which other transitional relief was provided in the Act; and (2) up to $27 million of bonds for the City of Baltimore, Maryland, to finance advances made by that City on or before October 19, 1983, pursuant to a voter referendum held before November 3, 1982, and (3) for certain bonds issued by the Eastern Maine Electric Cooperative with respect to Project No. 6, a joint venture with the Massachusetts Municipal Wholesale Electric Company.

Application of certain Internal Revenue Code requirements to bonds exempt from tax pursuant to other provisions of law

The Act clarifies that bonds issued pursuant to provisions of law other than the Code (non-Code bonds) must be issued in registered form. Additionally, the Act clarifies that the private (consumer) loan bond restriction applies to non-Code bonds. These clarifications are effective for bonds issued after March 28, 1985.

Exception for small-issue IDB principal user rule

The Act provides an exception from the small-issue IDB size limitations for specified amounts of bonds for certain specified electric generating facilities output from which will be sold to a nongovernmental person pursuant to agreements in accordance with the Public Utilities Regulatory Policies Act of 1978 (PURPA). But for the amendment, the purchasers of power under these PURPA agreements would be treated as principal users of the facilities.

Effective dates

The Act clarifies the private activity bond provisions to which the effective dates provided in 1984 Act section 631(c)(1) apply. These provisions are (1) the prohibition on Federal guarantees (Act sec. 622); (2) the aggregate limit for small issue bonds (Act sec. 623); (3) the restrictions on financing land, existing facilities, and certain specified facilities (Act sec. 627); (4) the rules relating to aggregation of certain related facilities, the definition of substantial user, and mixed use residential rental property (Act secs. 628(c), (d), and (e)); (5) the option for student loan bond authorities to issue taxable bonds (Act sec. 625(c)); (6) the public approval requirements for certain airports (Act sec. 628(f)); and (7) the authorization of tax-exempt financing for acquisition of a bankrupt railroad (Act sec. 629(b)).

The Act clarifies that the transitional exceptions contained in 1984 Act section 631(c)(3) apply only in the case of certain of the provisions enumerated in section 631(c)(1), as amended.

The Act further clarifies that the exception for obligations to finance facilities the construction, reconstruction, or rehabilitation of which was begun before October 19, 1983, applies only if the construction, reconstruction, or rehabilitation was completed on or after that date. Similarly, the exception for obligations issued to finance facilities with respect to which a binding contract to incur

significant expenditures for construction, reconstruction, rehabilitation, or acquisition was entered into before October 19, 1983, applies only if some of the expenditures are incurred on or after that date. For purposes of the binding contract rule, payments under an installment payment agreement are incurred no later than the date on which the property that is the subject of the agreement is delivered rather than on the due date of each installment.

The two clarifications to these transitional exceptions requiring activity (e.g. construction) or expenditures after October 18, 1983, apply to obligations issued after March 28, 1985; however, no inference is intended that the same rules, do not apply to obligations issued on or before that date.

The Act clarifies that, subject to transitional exceptions, the prohibition on tax-exempt financing for health clubs applies to obligations issued after April 12, 1984 (rather than December 31, 1983).

Further, the Act provides that the private loan bond restriction of the Act does not apply to tax-increment financing bonds issued before August 16, 1986. Tax-increment financing bonds eligible for this exception are bonds substantially all of the proceeds of which are to be used to finance—

(1) sewer, street lighting, or other governmental improvements to real property,

(2) the acquisition of any interest in real property pursuant to the exercise of eminent domain (or the threat thereof), the preparation of such property for new use, or the transfer of such interest to a private developer, or

(3) payments of reasonable relocation costs of prior users of such real property.

All of these activities must be carried out pursuant to a redevelopment plan adopted before the bonds are issued by the governing body of the general governmental unit in which the real property being redeveloped is located. Repayment of the bonds must be secured by pledges of that portion of any increase in real property tax revenues (or their equivalent) attributable to the redevelopment resulting from the issue. (The fact that a governmental unit may pledge its full faith and credit in addition to incremental property tax revenues does not violate this requirement.) Also, no facilities located (or to be located) on land acquired with tax-increment financing bond proceeds may be subject to a real property or other tax based on a rate or valuation method which differs from the rate and valuation method applicable to any other similar property located in the general governmental unit in which the real property being redeveloped is located. (The fact that property located in different tax assessment districts is subject to different assessments does not violate this restriction as long as no special assessments are levied with regard to the redevelopment activities.)

G. Technical Corrections to Miscellaneous Tax Provisions

1. Miscellaneous corporate provision (sec. 1875(b) of the Act and sec. 304 of the Code)

Prior Law

Under prior law, if a shareholder of a 50-percent owned corporation transfers stock of that corporation to another 50-percent owned corporation in exchange for property, the transaction is treated as a redemption of the shareholders' stock in the acquiring corporation. The transferred stock is considered to have been transferred by the shareholders as a contribution to capital of the acquiring corporation, and its basis is equal to the transferor's basis increased by any gain recognized to the transferor (sec. 362(a)).

Explanation of Provision

The Act provides that the contribution to capital rule will not apply if the shareholder is treated as having exchanged its stock (under sec. 302(a)). Thus, where section 302(a) applies, the acquiring corporation will be treated as purchasing the stock, for example, for purposes of section 338. The amendment is not intended to change the prior law treatment of the shareholder (including the shareholder's basis in the stock of the acquiring corporation).

2. Miscellaneous pension provisions (secs. 1875(c) and 1879(g) of the Act, sec. 713 of DEFRA, and secs. 62, 219, 401(k), 402, 404, 408, and 3405 of the Code)

Prior Law

Rollovers

Under prior law, as in effect before the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), a 10-percent additional income tax applied to distributions before age 59½, death, or disability from a qualified plan to an owner-employee (a sole proprietor who owned the entire interest in an unincorporated trade or business or a partner who owned more than 10 percent of a partnership). TEFRA extended this additional income tax to such early withdrawals by key employees (sec. 416(i)). TEFRA did not, however, provide a conforming amendment to prevent avoidance of the tax through a tax-free rollover by a key employee to a plan in which the individual was not a key employee.

The Deficit Reduction Act of 1984 (DEFRA) provided a conforming amendment to prohibit rollovers by key employees to plans for which the additional tax on early withdrawals was inapplicable. However, DEFRA also amended the additional tax on early withdrawals to apply to individuals who are 5-percent owners of the

employer, whether or not those individuals are key employees. Thus, after DEFRA, there continued to be a discrepancy between the class of individuals to whom the additional tax on early withdrawals applied (i.e., 5-percent owners) and the class of individuals for whom rollovers were restricted (i.e., key employees).

Excess contributions

Under prior law, contributions made to a qualified plan on behalf of a self-employed individual in excess of the amount deductible for the taxable year were subject to an excise tax, unless the excess was withdrawn before the due date of the tax return. DEFRA repealed this tax on excess contributions and the provision relating to the return of excess contributions, effective for taxable years beginning after December 31, 1983.

Deduction limits for self-employed individuals

Generally, effective for years beginning after December 31, 1983, TEFRA revised the definition of earned income so that the amount taken into account as the earned income of a self-employed individual corresponds to the amount of compensation of a common-law employee. Under TEFRA, in applying the rules relating to deductions and limitations under qualified plans, the earned income of a self-employed individual was computed after taking into account contributions by the employer to a qualified plan to the extent a deduction is allowed for the contributions. This provision was not intended to apply for purposes of determining whether contributions made on behalf of a self-employed individual were ordinary and necessary business expenses.

IRAs, SEPs

TEFRA generally increased the overall limits on contributions and benefits for self-employed individuals to conform to the generally applicable limits under qualified plans.

Limits

Generally, effective for years ending after July 1, 1982, TEFRA reduced the limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and simplified employee pensions (SEPs). TEFRA also provided rules for calculating the dollar limits applicable to alternate forms of benefits, benefits commencing prior to age 62, and benefits commencing after age 65. In calculating employer contributions required to fund benefit amounts not in excess of those limits (and deductions for those contributions), TEFRA provided that anticipated cost-of-living increases are not taken into account.

Pension withholding

Under prior and present law, payors generally are required to withhold tax from a designated distribution (the taxable part of a payment made from or under a pension, profit-sharing, stock bonus, or annuity plan, an IRA, a commercial annuity, or certain deferred compensation plans), unless the recipient elects not to have withholding apply. The withholding rules do not apply to certain distributions, such as those distributions that are otherwise considered wages.

Contributions on behalf of disabled individuals

TEFRA permitted an employer to elect to continue making deductible contributions to a profit-sharing or stock bonus plan on behalf of a permanently and totally disabled employee who has separated from service. A similar rule does not apply for contributions to a money purchase pension plan.

Explanation of Provisions

Rollovers

The Act coordinates the rules relating to qualifying rollover distributions (secs. 402(a)(5)(F)(ii) and 408(d)(3)) with those applicable to the additional income tax on early withdrawals. Distributions made after October 22, 1986 to or on behalf of an individual who is a 5-percent owner at the time of distribution may not be rolled over to a qualified plan. The act defines a 5-percent owner for this purpose as any individual who is a 5-percent owner (as defined in sec. 416(i)(1)(B)) at any time during the five plan years preceding the plan year in which the distribution is made.

The Act provides that distributions after December 31, 1983, but on or before July 18, 1984, may not be rolled over to a qualified plan if any part of the distribution is attributable to contributions made on behalf of an owner-employee. In addition, distributions to a 5-percent owner (as defined above) made after July 18, 1984, but on or before October 22, 1986, may not be rolled over to a qualified plan if any part of the distribution is attributable to contributions made on behalf of an employee while a key employee in a top-heavy plan.

See, however, the provisions of the Act relating to the extension of the additional income tax to all participants under tax-favored retirement arrangements. For years beginning on or after the effective date of those provisions, the restrictions on rollovers are repealed as deadwood because the additional tax on early withdrawals would apply to distributions from any plan without regard to the recipient's status as a 5-percent owner with respect to the plan making the distribution.

Excess contributions

The Act makes it clear that the repeal by DEFRA of the rule relating to the return of excess contributions made on behalf of a self-employed individual applies with respect to contributions made in taxable years beginning after December 31, 1983.

Deduction limits for self-employed individuals

The Act makes it clear that the DEFRA amendment to the definition of earned income did not change the TEFRA definition of earned income for purposes of the 15- or 25-percent limits on deductions (sec. 404). Rather, the change permitting earned income of a self-employed individual to be determined without regard to the deductions allowable for contributions to a qualified plan is to apply solely for purposes of determining the extent to which contributions made to a qualified plan are ordinary and necessary business expenses for purposes of the deduction rules (sec. 404(a)(8)(C)).

This provision is effective as if enacted in TEFRA. The DEFRA amendment, which had the effect of increasing the amount deductible on behalf of a self-employed individual to 15 or 25 percent of earned income before reduction for contributions to the plan on behalf of the self-employed individual, rather than 15 or 25 percent of earned income after reduction for contributions to the plan on behalf of the self-employed individual, is repealed, effective for taxable years beginning after December 31, 1984.

The Act also clarifies that the deduction available to a self-employed individual for contributions to a qualified plan is not necessarily limited to the cost of actual benefits provided for, or allocations to, the individual. Rather, subject to the usual deduction rules (sec. 404), a self-employed individual is permitted to deduct such individual's allocable share of contributions to a qualified plan. This clarification is effective as if enacted in TEFRA.

IRAs, SEPs

The Act conforms the limits on certain distributions of excess IRA contributions and the limits on employer contributions on behalf of certain officers, shareholders, or owner employees to SEPs to the dollar limit on annual additions to a qualified defined contribution plan. This provision is effective as if enacted in TEFRA.

Limits

The Act makes it clear that the rule precluding deductions based on anticipated cost-of-living adjustments to the benefit limits applies to limit benefits payable as a single life annuity commencing at age 62, as well as benefits paid in alternate forms, those commencing prior to age 62, and those commencing after age 65.

Pension withholding

The Act includes distributions of dividends for which the employer is permitted a deduction (sec. 404(k)) in the list of distributions to which the withholding rules do not apply.

Contributions on behalf of disabled individuals

The Act provides that deductible contributions may be continued on behalf of a permanently and totally disabled employee to any defined contribution plan, including a money purchase pension plan.

3. Effective date of provision relating to interest on tentative carrybacks and refund adjustments (sec. 1875(c) of the Act, sec. 6611(f) of the Code and sec. 714(n)(2) of the 1984 Act)

Prior Law

The 1984 Act provided that, for purposes of computing interest on refunds arising from net operating loss carrybacks where a tentative adjustment claim is filed, the refund is treated as filed on the date that the tentative adjustment claim is filed. Prior to this amendment, some taxpayers filed an amended return claiming a refund based on a carryback, waited until the expiration of the 45-day period within which, if a refund is made, no interest is paid, and then filed for a tentative adjustment, which provides for rapid payment. These taxpayers consequently defeated the intent of the interest rules relating to tentative adjustments by obtaining interest on the tentative adjustment relating back to the due date of the return for the year of the loss. The provision of the 1984 Act that prevented this misapplication of the intended rules relating to the payment of interest was added to the Act in conference and was effective as if it were included in the Tax Equity and Fiscal Responsibility Act of 1982.

Explanation of Provision

The Act provides that the provision of the 1984 Act (sec. 714(n)(2)) relating to interest on tentative carrybacks and refund adjustments is effective only with respect to applications filed after July 18, 1984.

4. Foreign Sales Corporations

a. Treatment of income that a FSC earns without using administrative pricing rules (sec. 1876(a)(1) of the Act and sec. 927 of the Code)

Prior Law

In general, the 1984 Act exempts a fraction of the foreign trade income of a Foreign Sales Corporation (FSC) from tax. The fraction is 15/23 if the FSC uses an administrative pricing rule to determine its income (16/23 if the FSC shareholder is not a corporation). The 1984 Act generally denies foreign tax credits for taxes imposed on foreign trade income, but allows a 100-percent dividends received deduction for dividends distributed out of earnings and profits of a FSC that are attributable to that income.

Different rules apply, however, when a FSC does not use the Act's administrative pricing rules. Then, a fraction (generally 30 or 32 percent) of the FSC's foreign trade income is exempt from U.S. tax, and the balance (70 or 68 percent) is so-called "section 923(a)(2) non-exempt income." In general, this section 923(a)(2) non-exempt income is subject to one of three sets of pre-existing rules governing income of foreign corporations generally. First, it may be taxable currently to the FSC as income effectively connected with a U.S. trade or business. Second, it may be taxable to the FSC's U.S. shareholders under the anti-avoidance rules of subpart F. Third, it may be exempt from current taxation, and taxable only on repatriation to U.S. shareholders.

The 1984 Act makes this section 923(a)(2) non-exempt income ineligible for some treatment that it applies to other foreign trade income. For instance, foreign taxes on this income may be creditable, but distributions out of earnings and profits attributable to this income are not eligible for the 100-percent dividends received deduction.

Explanation of Provision

The Act conforms the treatment of effectively connected foreign trade income that a FSC earns without administrative pricing rules (effectively connected section 923(a)(2) non-exempt income) to that of other effectively connected foreign trade income. Taxes on that income are not creditable, but the Act allows a 100-percent dividends received deduction for dividends distributed out of earnings and profits of a FSC that are attributable to that income. That is, this income will be subject to full U.S. tax at the FSC level, but not again at the shareholder level.

b. Treatment of foreign trade income under section 1248 (sec. 1876(a)(2) of the Act and sec. 1248(d)(6) of the Code)

Prior Law

Section 1248 treats gain realized by certain U.S. persons on the disposition of stock in a foreign corporation as ordinary income to the extent of allocable earnings and profits. The 1984 Act excluded all FSC earnings and profits attributable to foreign trade income from ordinary income treatment under section 1248, whether or not those earnings would have been eligible for the 100 percent dividends received deduction had the FSC distributed them.

Explanation of Provision

The 1986 Act refines the 1984 Act's restriction of section 1248 ordinary income treatment on disposition of FSC shares. It provides that FSC earnings and profits that would be taxable on a distribution are subject to ordinary income treatment under section 1248.

c. Clarification of corporate preference cutbacks (sec. 1876 (b) and (i) of the Act and secs. 291, 923, and 995 of the Code)

Prior Law

Prior law provided and present law provides for a reduction in certain corporate tax preferences. The 1984 Act, in extending this reduction of corporate preferences, sought to reduce the exempt portion of the foreign trade income of a FSC by 1/17 if the shareholder of the FSC is a corporation. The statute indicates that the cutback applies "with respect to" the corporate shareholder of the FSC. Congress intended that the cutback apply at the FSC level, which would reduce the portion of the FSC's foreign trade income that is exempt from tax at that level.

Prior law provided and present law provides a similar reduction in benefits in the case of deferred DISC income. A shareholder of a DISC was treated as having received a distribution taxable as a dividend equal to 1/17 of the excess of the taxable income of the DISC over certain other deemed distributions. The reduction in benefits applied whether or not the shareholder of the DISC was a corporation. Congress intended to limit this cutback to cases where the shareholder of the DISC is a corporation.

Congress intended that the amount of deemed DISC distribution attributable to international boycott activities be computed by multiplying 16/17 of the excess taxable income by the international boycott factor. Prior law erroneously indicated that the deemed distribution was computed by multiplying 1/17 of the excess taxable income by the international boycott factor.

Explanation of Provision

The Act clarifies that the FSC preference cutback applies with respect to the FSC, rather than the corporate shareholder of the FSC. The exempt portion of foreign trade income is reduced from 32 to 30 percent in cases in which income is determined without regard to the administrative pricing rules, and from 16/23 to 15/23 in cases in which income is determined under the administrative pricing rules. The Act also provides that the portion of foreign trade income that is exempt will be adjusted, under regulations, to take into account any shareholders that are not C corporations for whom there is no preference cutback.

The Act also clarifies that the deemed distribution of 1/17 of the excess taxable income of the DISC applies only in the case of a shareholder which is a C corporation. Neither the FSC nor the DISC corporate preference cutback applies when an S corporation is the shareholder.

In addition, the Act corrects the method for computing the amount of the deemed distribution attributable to international boycott activities. This amount is computed by multiplying 16/17 of the excess taxable income by the international boycott factor.

d. Treatment of foreign trade income under subpart F (sec. 1876(c) of the Act and secs. 951 and 952 of the Code)

Prior Law

The 1984 Act contains a sentence designed to prevent shareholder level taxation under Subpart F's anti-avoidance rules of income already taxed at the FSC level. That sentence appears in a Code provision designed to prevent shareholder level taxation of earnings and profits attributable to most foreign trade income, whether or not taxed at the FSC level.

Explanation of Provision

The Act makes it clear that there is to be no shareholder level taxation under Subpart F's anti-avoidance rules of income already taxed at the FSC level.

e. Dividends received deduction for certain distributions from a FSC (secs. 1876(d)(1) and 1876(j) of the Act and sec. 245 of the Code)

Prior Law

Prior law allowed an 85-percent dividends received deduction for dividends received from a foreign corporation if half or more of the foreign corporation's gross income (over a 3-year period) was effectively connected with the conduct of a U.S. trade or business. Present law allows a somewhat similar 80-percent dividends received deduction. These deductions generally apply, on a pro rata

basis, to the extent that the foreign corporation's gross income is effectively connected income.

The 1984 Act treats all interest, dividends, royalties, and other investment income received or accrued by a FSC as income effectively connected with a trade or business conducted through a permanent establishment in the United States. If enough of a FSC's income was effectively connected, the FSC would have met the 50-percent of gross income test that would have qualified its U.S. corporate shareholders for the 85-percent dividends received deduction for dividends attributable to this passive income. If the FSC did not meet the 50-percent of gross income test, however, then none of its dividends attributable to passive income could qualify for the 85-percent dividends received deduction. Whether the FSC met the 50-percent of gross income test depended on a number of factors.

The 1984 Act also provides a 100-percent dividends received deduction for distributions out of earnings and profits attributable to foreign trade income of a FSC other than section 923(a)(2) non-exempt income.

Explanation of Provision

In general, the Act provides an 85-percent dividends received deduction for any dividend received by a U.S. corporation from a FSC that is distributed out of earnings and profits attributable to "qualified interest and carrying charges." A technical correction will be needed to reduce the amount of this deduction to 80 percent to reflect the policy of section 611 of the Act, which reduces the corporate dividends received deduction generally from 85 percent to 80 percent. Qualified interest and carrying charges mean interest or carrying charges derived from a transaction that results in foreign trade income. Passive income that is not directly related to foreign trade income is not eligible for this treatment.

In addition, the Act specifies that gross income giving rise to earnings and profits attributable to foreign trade income or to qualified interest and carrying charges of a FSC will not be taken into account for purposes of calculating a dividends received deduction under the general rules (with respect to other income of the FSC). Thus, for example, such income will not be taken into account in determining whether a dividend attributable to such other income allows a dividends received deduction.

f. Separate foreign tax credit limitation for FSC income (sec. 1876(d)(2) of the act and sec. 904 of the code)

Prior Law

Distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income are subject to a separate foreign tax credit limitation.

Explanation of Provision

Under the Act, distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income or qualifying interest and carrying charges are subject to a separate foreign tax credit limitation. The purpose of this provision is to prevent this income from absorbing foreign tax credits from other income, and to prevent other income from absorbing foreign tax credits (if any are allowable) on this income.

g. Coordination of foreign tax credit for foreign corporations and deemed paid credit (sec. 1876(d)(3) of the Act and secs. 902 and 906 of the Code)

Prior Law

A foreign corporation may credit foreign taxes imposed on income that is effectively connected with the conduct of a trade or business in the United States (sec. 906). A corporate U.S. shareholder owning 10 percent or more of the voting stock of a foreign corporation may be eligible for a deemed paid foreign tax credit when the corporation pays a dividend (sec. 902). This deemed paid credit allowed such a U.S. shareholder to credit again the taxes that the foreign corporation paid. If enough of the foreign corporation's income is effectively connected, its U.S. shareholders could be eligible for a dividends received deduction for the dividends the foreign corporation pays them.

The 1984 Act makes all investment income of a FSC effectively connected income. It generally makes the taxable portion of foreign trade income of a FSC effectively connected income.

Explanation of Provision

The Act provides that taxes paid or accrued with respect to, and accumulated profits attributable to, income of a foreign corporation that is effectively connected with the conduct of a trade or business within the United States shall not be taken into account for purposes of the deemed paid credit. This provision is designed to prevent a double tax benefit.

h. Exchange of information requirements (sec. 1876(e) of the Act and sec. 927(e)(3) of the Code)

Prior Law

A corporation (other than a corporation formed in an eligible U.S. possession) cannot qualify as a FSC unless there was in effect, at the time of creation or organization of the FSC, with the foreign country under whose laws it was created or organized, either (1) an agreement allowing tax benefits under the Caribbean Basin Initiative, or (2) an income tax treaty with respect to which the Secretary of the Treasury certifies that the exchange of information program with respect to the country carries out the purposes of paragraph 927(e)(3) of the Code. The purposes of that paragraph are not specified in the statute. An agreement under the Caribbean Basin Initiative must generally provide for disclosure for civil tax purposes of information that is otherwise confidential under local law, but may provide for nondisclosure of such information if the President determines that the agreement as negotiated is in the national security interest of the United States.

A FSC (other than a small FSC) must maintain its principal bank account outside the United States at all times during the taxable year.

Explanation of Provision

The Act provides that a corporation cannot continue to qualify as a FSC if its country of incorporation, having once qualified as a host country for FSCs, ceases to qualify. Notwithstanding a Treasury determination that a country ceases to qualify, under Treasury regulations, corporations established in that country continue to be eligible for FSC benefits for the six months following the determination.

The Act also makes it clear that a country may qualify as a host country for FSCs by entering into an exchange of information agreement of the type that allows tax benefits under the Caribbean Basin Initiative, whether or not that country is eligible to be a beneficiary of the Caribbean Basin Initiative. The Act also specifies that the national security exception under the Caribbean Basin Initiative will not apply for purposes of FSC; thus, to be acceptable for FSC purposes, an exchange of information agreement must require disclosure of confidential information.

The Act also makes it clear that an income tax treaty will allow a country to qualify as a host country for FSCs only if the Secretary certifies that its exchange of information program is satisfactory in practice for purposes of the Internal Revenue Code. That is, the program should provide to the United States in practice such information as may be relevant to the determination of a U.S. tax liability or whether a tax-related criminal offense has been committed.

In addition, the Act makes it clear that, for a corporation to qualify as a FSC, the exchange of information program of the country of its incorporation must cover that particular corporation. The Act makes it clear, for example, that a corporation incorporated in a treaty partner country but not subject to the exchange of information program of the treaty because it is not resident in the treaty partner does not qualify for FSC status.

The Act makes it clear that a FSC (other than a small FSC) must maintain its principal bank account in a possession of the United States or in a country that qualifies as a host country for FSCs at all times during the taxable year. This requirement is effective for periods after March 28, 1985.

i. Coordination with possessions taxation (sec. 1876(f) of the Act and sec. 927(e)(5) of the Code)

Prior Law

Under prior law, a possession of the United States could not impose a tax on any foreign trade income of a FSC that was derived before January 1, 1987. Foreign trade income is generally the gross income of a FSC attributable to the sale or lease of export property outside the United States. Thus, foreign trade income may be derived from the sale or lease of export property (or performance of services) within a U.S. possession by a FSC located in the possession. Congress intended, with respect to any foreign trade income or passive income of a FSC that a possession is permitted to tax, that the possession would also be permitted to exempt such income from tax. In some cases, U.S. tax imposed on certain income connected with a possession is covered over to the possession.

Explanation of Provision

The Act provides that a U.S. possession is not prohibited from imposing a tax on any income attributable to the sale of property or the performance of services for use, consumption or disposition within the possession. Thus, for example, the Virgin Islands is not prohibited from imposing a tax on the income derived from the sale of goods by a U.S. company, through its FSC located in the Virgin Islands, to customers in the Virgin Islands.

The Act clarifies that no provision of law may be construed as prohibiting a U.S. possession from exempting from tax any foreign trade income or passive income (e.g., interest, dividends or carrying charges) of a FSC. The Act also clarifies that no provision of law may be construed as requiring any income tax imposed by the United States on a FSC to be covered over (or otherwise transferred) to any U.S. possession.

j. Interest on DISC-related deferred tax liability (sec. 1876(g) of the Act and sec. 995(f) of the Code)

Prior Law

A DISC may defer income attributable to $10 million or less of qualified export receipts. However, an interest charge is imposed on the shareholders of the DISC. The amount of the interest is based on the tax otherwise due on the deferred income, computed as if the income were distributed.

Explanation of Provision

The Act clarifies that an interest charge is to be imposed on the deferred income of a former DISC in the same manner that it is imposed on a DISC.

k. Exemption of accumulated DISC income (sec. 1876(h) of the Act and sec. 805(b)(2) of the 1984 Act)

Prior Law

Accumulated DISC income which is derived before January 1, 1985 is generally exempt from tax. This result is achieved by treating actual distributions made after December 31, 1984 by a DISC (or former DISC which was a DISC on December 31, 1984) as previously taxed income with respect to which there had previously been a deemed distribution. It was unclear under prior law whether a distribution in liquidation is an "actual distribution" for purposes of this provision. It was also unclear how such a distribution would be treated for purposes of computing the earnings and profits of any corporate shareholder of the DISC.

Explanation of Provision

The Act clarifies that for purposes of exempting from tax accumulated DISC income, the term actual distribution includes a distribution in liquidation. The Act further clarifies that the earnings and profits of any corporation receiving a distribution that is not included in gross income because it is treated as previously taxed income under this provision will be increased by the amount of the distribution.

l. Effective date of tax year conformity requirement (sec. 1876(i) of the Act and sec. 805(a)(4) of the 1984 Act)

Prior Law

In general, the taxable year of any DISC must be the taxable year of its owner. If the DISC has more than one shareholder, the taxable year of shareholders with a plurality of voting power controls. This rule applies to any DISC established after March 21, 1984.

Explanation of Provision

The Act provides that the rule requiring conformity of tax years applies to taxable years beginning after December 31, 1984. The Act makes it clear that this rule will apply to interest-charge DISCs, whether or not newly formed.

m. Treatment of certain qualifying distributions from a DISC (sec. 1876(k) of the Act and sec. 996 of the Code)

Prior Law

To qualify as a DISC, 95 percent of a corporation's gross receipts must be "qualified export receipts." If a corporation seeking to qualify as a DISC does not meet that 95-percent test for a year, it may, after that year's close, qualify retroactively by distributing to its shareholders property in an amount equal to taxable income attributable to gross receipts that are not qualified export receipts. Generally, under prior law, one-half of this kind of distribution to meet qualification requirements was treated as coming out of accumulated DISC income, and one-half was treated as coming out of previously taxed income. Under prior law, generally, one-half of a DISC's income was deemed distributed to its shareholders. The treatment of a distribution to meet qualification requirements was based on the notion that one-half of a DISC's taxable income attributable to all gross receipts had already been taxed as a deemed distribution, while the other half was deferred. Under the 1984 Act, one-seventeenth of a DISC's income is deemed distributed to shareholders that are C corporations.

Explanation of Provision

In the case of a shareholder that is a C corporation, the Act would treat 16/17 of a DISC's distribution to meet the qualified export receipts requirement as coming out of accumulated DISC income, with generally only 1/17 coming out of previously taxed income. This treatment reflects the post-1984 treatment of DISC income attributable to a shareholder that is a C corporation, whereunder only 1/17 is deemed distributed and taxed currently.

n. Treatment of certain receipts from another FSC (sec. 1876(l) of the Act and sec. 924 of the Code)

Prior Law

A FSC could not treat as foreign trading gross receipts any receipts from another FSC that is a member of the same controlled group (Code sec. 924(f)(1)). The prohibition of sales through related FSCs prevents pyramiding of benefits under the gross receipts method of calculating income.

Explanation of Provision

The Act permits FSCs to treat receipts from another FSC that is a member of the same controlled group as foreign trading gross receipts, if no FSC in the group uses the gross receipts method of calculating income.

o. Treatment of certain former export trade corporations (sec. 1876(m) of the Act and sec. 805(b) of the 1984 Act)

Prior Law

The 1984 Act provides that accumulated DISC income, in certain circumstances, will not be subject to U.S. tax. Similarly, the Act provides that certain income of active export trade corporations (as defined in Code sec. 971) will not be subject to U.S. tax, but only if the export trade corporation either elects to be treated as a FSC or surrenders its export trade corporation status.

Explanation of Provision

The Act extends to corporations that had been export trade corporations at some point but that were not export trade corporations for their most recent taxable year ending before July 18, 1984, the same treatment that the Act extended to active export trade corporations. To qualify for this treatment, a former export trade corporation either must be precluded (under statutory rules) from again qualifying as an export trade corporation, or must elect never again to qualify as such.

p. Distributions of accumulated DISC income received by cooperatives (sec. 1876(n) of the Act and sec. 805(b)(2) of the 1984 Act)

Prior Law

The 1984 Act excludes from gross income certain distributions of accumulated DISC income. That exclusion applies to certain accumulated DISC income received by certain cooperative organizations.

Explanation of Provision

The Act provides that amounts excluded from the gross income of a cooperative organization described in Code section 1381 by sec. 805(b)(2)(A) of the Act will not be included in the gross income of the cooperative's members when distributed to them. Distributions arising from tax-free accumulated DISC income will not be deductible by the cooperative organization. This treatment reflects the concept that a cooperative organization is a flow-through entity analogous to a partnership for the purpose of the exclusion of certain accumulated DISC income from tax.

q. Effective date of certain FSC requirements (sec. 1876(o) of the Act and sec. 805(a) of the 1984 Act)

Prior Law

The foreign management and foreign economic process requirements for eligibility for FSC benefits (Code sec. 924(c) and (d)) generally apply in taxable years ending after December 31, 1984. Transition rules are provided for existing contracts taken over by a FSC. Thus, those requirements do not apply with respect to contracts entered into (or planned to be entered into) before March 16, 1984, with respect to which the taxpayer uses the completed contract method of accounting. In addition, those requirements do not apply for the first two taxable years of a FSC ending after January 1, 1985, with respect to contracts entered into before March 16, 1984. Finally, those requirements do not apply for the first taxable year of a FSC ending after January 1, 1985, with respect to contracts entered into after March 15, 1984, and before January 1, 1985.

Code section 925(c) provides that a FSC may use the administrative pricing rules only if certain activities with respect to a sale are performed by or on behalf of the FSC. The 1984 Act did not provide a transition rule for this requirement.

Explanation of Provision

The Act provides that any requirement of Code section 924(c) or (d) or section 925(c) that should have been met before January 1, 1985, will be treated as having been met with respect to any lease entered into before that date for a period longer than three years. Those requirements will also be treated as having been met with respect to any contract entered into before January 1, 1985, with respect to which the taxpayer uses the completed contract method of accounting. Finally, in the case of any other contract entered into before January 1, 1985, those requirements will be treated as having been met, but only with respect to the first three taxable years of a FSC ending after January 1, 1985, or such later taxable years as the Secretary may prescribe.

5. Highway Revenue Provisions

a. Excise tax refund for diesel fuel used in school buses (sec. 1877(b) of the Act and sec. 6427(b) of the Code)

Prior Law

The 1984 Act allows a complete refund of the 15-cents-a-gallon excise tax paid on diesel fuel which is used by private contractors to provide scheduled local bus service to the general public over regular routes, because the service substitutes for publicly provided service that would use tax-exempt fuel. However, the 1984 Act failed to provide a complete refund when private contractors supply school bus service, the diesel fuel for which would be tax-exempt if the service were supplied by a State or local government or nonprofit school. The effective excise tax rate on this fuel was 3 cents a gallon (tax of 15 cents a gallon, less refund of 12 cents a gallon), the effective rate that generally applies to diesel fuel used in privately operated buses.

Explanation of Provision

The Act allows a full 15-cents-a-gallon refund of excise tax on diesel fuel used in a school bus while engaged in the transportation of students and school employees.

b. Piggyback trailers (sec. 1877(c) of the Act and sec. 4051(d)(3) of the Code)

Prior Law

A 12-percent excise tax is imposed on the first retail sale of a heavy truck trailer. The 1984 Act temporarily reduced this excise tax rate to 6 percent for piggyback trailers (truck trailers equipped to be lifted onto and transported by railroad flatcars) sold after July 17, 1984, and before July 18, 1985. An additional tax is imposed if and when a trailer that was taxed at this reduced rate subsequently fails to qualify for it because, for example, the trailer is no longer used principally in connection with trailer-on-flatcar service. This additional tax equals the 6 percent excise tax that was not collected on the first retail sale by virtue of the temporarily reduced rate for piggyback trailers.

Explanation of Provision

The Act provides that the additional 6 percent excise tax imposed by section 4051(d)(3) will not apply to a piggyback trailer after 6 years have elapsed from the date of the first retail sale of the trailer.

6. Certain helicopter uses exempt from aviation excise taxes (sec. 1878(c) of the Act and secs. 4041 and 4261 of the Code)

Prior Law

The 1984 Act expands the exemptions from the aviation excise taxes previously provided with respect to helicopters engaged in qualified timber and hard mineral resource activities where no FAA navigational facilities or airport are used to include helicopters engaged in qualified oil and gas activities.

Explanation of Provision

The Act clarifies that the exemptions for oil and gas activities are coterminous with those previously provided for hard mineral resource activities. Therefore, helicopters engaged in the exploration for, or the development or removal of, oil and gas will be exempt from the aviation excise taxes, provided the helicopters do not use Federally aided airports or Federal airway facilities.

7. Acquisition indebtedness of certain exempt organizations (sec. 1878(e) of the Act and sec. 514(c)(9) of the Code)

Prior Law

The 1984 Act provided rules excepting certain debt-financed real estate held by qualified pension trusts and educational institutions from the unrelated business income tax. In the case where the exempt organization is a partner in a partnership (along with taxable entities), that Act provided that each allocation to the exempt organization be a qualified allocation, within the meaning of the tax-exempt entity leasing rules of section 168(j)(9).

Explanation of Provision

The Act provides that the qualified allocation requirement apply only if the principal purpose of any allocation which is not a qualified allocation is the avoidance of income tax.

8. Military housing rollover (sec. 1878(g) of the Act and sec. 1034(h)(2) of the Code)

Prior Law

The 1984 Act provides an extended nonrecognition period for rollover of gain on sale of a personal residence in the case of military personnel stationed outside the United States, or required to reside in government quarters at certain remote base sites within the United States. In such a case, the nonrecognition rollover period otherwise allowable under Code section 1034(h)(1) is not to expire until the last day on which the person is stationed outside the United States or is required to reside in government quarters at a remote base site within the United States, except that this extended nonrecognition period cannot exceed eight years after the date of the sale of the old residence. This provision applies to sales of old residences occurring after July 18, 1984.

Explanation of Provision

The extended nonrecognition period under Code section 1034(h)(2) is not to expire before the day which is one year after the last day on which the taxpayer is stationed outside the United States or is required to reside in government quarters at a remote base site within the United States, except that this extended nonrecognition period cannot exceed eight years after the date of the sale of the old residence. This modification conforms the provision to the Senate amendment, which was adopted by the conference committee on the 1984 Act.

9. Effective date for disallowance of deduction for costs of demolishing structures (sec. 1878(h) of the Act and sec. 280B of the Code)

Prior Law

Costs and other losses incurred in connection with the demolition of buildings must be added to the basis of the land on which the demolished buildings were located in all cases, rather than claimed as a current deduction. Before enactment of the 1984 Act, this rule applied only to certified historic structures. The expanded provision is effective for taxable years beginning after December 31, 1983.

Explanation of Provision

The Act clarifies that the expanded prohibition on current deduction of costs and other losses incurred in connection with demolition applies only to demolitions commencing after July 18, 1984, in the case of buildings other than certified historic structures. For this purpose, if a demolition is delayed until the completion of the replacement structure on the same site, the demolition shall be treated as commencing when construction of the replacement structure commences.

The Act also allows the unrecognized basis in specified demolished structures to be allowed as an ordinary deduction in the year of demolition.

A transitional rule is provided in a specified case where plans for the demolition were in place on July 18, 1984.

10. Regulated investment companies (sec. 1878(j) of the Act and sec. 852 of the Code)

Prior Law

All regulated investment companies (RICs) are required to comply with regulations prescribed by the Treasury for the purpose of ascertaining its stock ownership (sec. 852(a)(2)). Under prior law, as modified by the 1984 Act, a personal holding company may be eligible to be a RIC. The 1984 Act provided that any investment company taxable income of a RIC that is a personal holding company is taxed at the highest rate applicable to corporations.

Explanation of Provision

The provisions of the Act that permitted personal holding companies to qualify as RICs eliminated the necessity for a RIC to keep shareholder records that were intended to assure that it was not a personal holding company and thereby could qualify as a RIC. Accordingly, the Act eliminates the requirement that adequate shareholder records must be kept in order for a corporation to qualify as a RIC. Nevertheless, the Act provides that the investment company

taxable income of a RIC that does not keep such records would be subject to tax at the highest corporate rate, since such treatment is provided for RICs that are personal holding companies.

11. Waiver of estimated tax penalties (sec. 1879(a) of the Act)

Prior Law

Under prior and present law, if the withholding of income taxes from wages does not cover an individual's total income tax liability, the individual, in general, is required to file estimated tax returns and make estimated tax payments. Also, corporations are normally required to make quarterly estimated tax payments. An underpayment of an estimated tax installment will, unless certain exceptions are applicable, result in the imposition of an addition to tax on the amount of underpayment for the period of underpayment (secs. 6654 and 6655, with the rate as determined under sec. 6621).

The 1984 Act, enacted on July 18, 1984, made several changes which increased tax liabilities from the beginning of 1984.

Explanation of Provision

The Act allows individual taxpayers until April 15, 1985, and corporations until March 15, 1985 (the final filing dates for calendar year returns) to pay their full 1984 income tax liabilities without incurring any additions to tax on account of underpayments of estimated tax to the extent that the underpayments are attributable to changes in the law made by the Tax Reform Act of 1984.

In order to minimize any administrative problems to the Internal Revenue Service, it will be expected that taxpayers notify the IRS if they are entitled to the benefits of this provision. The IRS will not be required to notify taxpayers of possible relief under this provision.

II. TECHNICAL CORRECTIONS TO MISCELLANEOUS REVENUE PROVISIONS

1. Orphan drug credit (sec. 1879(b) of the Act and sec. 28 of the Code)

Prior Law

A 50-percent tax credit is available for qualified clinical testing expenses that are necessary to obtain the approval of the Food and Drug Administration for the commercial sale of a drug for a rare disease. The term "clinical testing" is defined, in part, by reference to the date on which an application with respect to a drug is approved under section 505(b) of the Federal Food, Drug, and Cosmetic Act. The term "rare disease or condition" is defined as any disease or condition that occurs so infrequently in the United States that the taxpayer has no reasonable expectation of recovering the cost of developing and marketing a drug for such disease or condition from sales in the United States.

Explanation of Provision

The Act clarifies that, in the case of a drug that is a biological product, "clinical testing" is defined, in part, by reference to the date on which a license for such drug is issued under section 351 of the Public Health Services Act. The Act also redefines the term "rare disease or condition" as any disease that (1) affects less than 200,000 persons in the United States, or (2) affects more than 200,000 persons in the United States but for which there is no reasonable expectation that the cost of developing and making available a drug for such disease in the United States will be recovered from sales of such drug in the United States. This will conform the provisions of the tax credit with the provisions of the Federal Food, Drug, and Cosmetic Act.

The provision applies to amounts paid or incurred after December 31, 1982.

2. Credit for producing fuel from nonconventional source (sec. 1879(c) of the Act and sec. 29 of the Code)

Prior Law

Prior and present law provides a credit for certain fuels produced by a taxpayer and sold to an unrelated party.

Explanation of Provision

The Act provides that the credit may be allowed where the sale to an unrelated person is made by a corporation which files a consolidated return with the corporation producing the fuel. The provi-

sion applies as if included in section 231 of the Crude Oil Windfall Profit Tax Act of 1980.

3. Report of refunds by Joint Committee to Congress (sec. 1879(e) of the Act and sec. 6405(b) of the Code)

Prior Law

The Code (sec. 6405(b)) required the Joint Committee on Taxation to make an annual report to Congress setting forth the proposed tax refunds and credits submitted by the Internal Revenue Service to the Joint Committee for its review, including the names of the taxpayers and amounts involved. It is unclear whether this requirement was overridden by the tax return disclosure limitations (sec. 6103) enacted in 1976. Because of this apparent conflict, these reports have not been submitted in recent years and the Joint Committee believes it appropriate to delete the requirement to submit this report.

Explanation of Provision

The Act repeals the requirement that the Joint Committee on Taxation submit an annual report to Congress on proposed IRS tax refunds and credits.

4. Rural electric cooperative cash or deferred arrangements (sec. 1879 of the Act and sec. 401(k) of the Code)

Prior Law

Under the Code, gross income may include amounts actually or constructively received as income. For example, under the rules of constructive receipt, the gross income of an individual includes compensation that has been earned and that would have been received but for the individual's election to defer its receipt. Prior and present law provides for an exception to the rules of constructive receipt in the case of employer contributions under a qualified cash or deferred arrangement.

If a tax-qualified profit-sharing or stock bonus plan (or certain pre-ERISA money purchase pension plans) meets certain requirements (a qualified cash or deferred arrangement), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

Because a qualified stock bonus plan is generally required to distribute benefits in the form of employer stock, a qualified stock bonus plan may not be maintained by a governmental unit or by a tax-exempt membership organization. Under the Code, employer contributions to a qualified profit-sharing plan may be made only from preset or accumulated employer profits.

It was unclear under prior law whether an employer that was a governmental entity or a tax-exempt organization may maintain a qualified cash or deferred arrangement because such an organization may not have stock or profits in the usual sense of those terms.

Explanation of Provision

The Act clarifies that any organization that is exempt from tax and that is engaged primarily in providing electric service on a mutual or cooperative basis is eligible to maintain a qualified cash or deferred arrangement. This provision also applies to a national association of such tax-exempt organizations.[1]

This provision applies to plan years beginning after December 31, 1984.

5. Definition of newly discovered oil (sec. 1879(h) of the bill and sec. 4991 of the Code)

Prior Law

Under prior and present law, the windfall profit tax is imposed at a lower rate on newly discovered oil than on other oil. Generally, the term "newly discovered oil" has the meaning given to it by the June 1979 energy regulations.

The legislative history to the Crude Oil Windfall Profit Tax Act of 1980 indicates that the term was also to include production from a property which did not produce oil in commercial quantities during calendar year 1978. That history indicates that it includes production from a property on which oil was produced in 1978 if that production was incident to the drilling of exploratory or test wells and was not part of continuous or commercial production from the property during 1978.

Explanation of Provision

The Act clarifies that the term "newly discovered oil" includes production from a property so long as not more than 2200 barrels was produced from the property in 1978 and no well on the property was in production for more than 72 hours during that year (whether or not the oil was sold). For purposes of this test, a dual completion well shall be treated as two wells, i.e., one well for each horizon. This provision is intended to clarify the "test well" exception described in the Conference Report accompanying the Crude Oil Windfall Profit Tax Act of 1980. No inference is intended as to the application of similar principles in areas other than section 4991(e)(2).

6. Refunds with respect to medicinal alcohol (sec. 1879(i) of the Act, and sec. 7652 of the Code)

Prior Law

Under prior and present law, a special excise tax is imposed on articles coming into the United States from Puerto Rico or the Virgin Islands, equal to the tax that would be imposed if the article were manufactured in the United States (sec. 7652).

[1] See, also, discussion of the rules relating to cash or deferred arrangements in *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), Title XI, Part A.2.

Explanation of Provision

The Act clarifies that medicinal alcohol produced in Puerto Rico and the Virgin Islands is eligible for refunds of the tax on distilled spirits paid when the alcohol is brought into the United States. For purposes of the refunds, Puerto Rican and Virgin Islands producers of medicinal alcohol are treated as United States persons, except the amount of the refund is determined as if tax were paid at the rate eligible for cover over under section 7652.

7. Allowance of investment tax credit to members of certain tax-exempt religious organizations (sec. 1879(j) of the Act and sec. 48 of the Code)

Prior Law

Prior and present law provides an income tax exemption for a religious or apostolic association or corporation if (1) it has a common treasury or community treasury, even if it engages in business for the common benefit of the members, and (2) its members include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the organization's taxable income for such year (sec. 501(d)). Any amount so included in the gross income of a member is treated as a dividend received. Thus, members of section 501(d) organizations file individual tax returns and pay income tax on their pro rata shares of organization income.

The Code allows an investment tax credit for certain acquisitions of depreciable property (sec. 38(a)). In the case of such property used by a tax-exempt organization, however, the credit is not allowed unless the property is used in an unrelated trade or business the income of which is subject to tax under section 511 (sec. 48(a)(4)). The Ninth Circuit has ruled that since section 501(d) organizations are not subject to the section 511 tax on unrelated business taxable income, neither the organization nor its members on their tax returns can claim the investment tax credit for depreciable property acquired by the organization (*Kleinsasser v. U.S.*, 707 F.2d 1024 (9th Cir. 1983)).

Explanation of Provision

The Act provides that, for purposes only of the investment credit rules in section 48(a)(4), any business which is conducted by an eligible section 501(d) organization for the common benefit of its members and the taxable income from which is included in the gross income of its members is to be treated as an unrelated business. Accordingly, the acquisition of depreciable property by an eligible section 501(d) organization for use in such a business gives rise to an investment tax credit to the same extent as if the property had been acquired by a section 501(c)(3) organization for use in an unrelated business.

Under the provision, the amount of such qualified investment by a section 501(d) organization is apportioned pro rata among its members in the same manner as its taxable income is allocated. The Act does not allow any credit for such investment to a member who claimed any other type of investment credit, and prohibits the reallocation of any such disallowed credit to other community members. The used-property credit limitation and credit recapture rules apply at the organization level.

The provisions apply to any organization which elects to be treated as an organization described in section 501(d) and which is exempt from tax under section 501(a), and which does not provide a substantially higher standard of living for any person or persons than it does for the majority of the members of the community.

The provision applies to periods after 1978 (under rules similar to those in Code sec. 48(m)).

8. Mutual savings banks (sec. 1879(k) of the Act and sec. 501(c)(14) of the Code)

Prior Law

The Economic Recovery Tax Act (ERTA) provided that a stock association which is subject to the same regulation as a mutual savings bank is treated as a mutual savings bank and thus eligible to compute its bad debt deduction under section 593.

Explanation of Provision

The Act provides that a stock association which is treated as a mutual savings bank for purposes of computing a bad debt deduction is also treated as a mutual savings bank for purposes of the exemption for mutual organizations insuring these banks (sec. 501(c)(14)(B)). The provision is effective as if enacted in ERTA.

9. Reorganization of investment companies (sec. 1879(l) of the Act and sec. 368(a)(2)(F) of the Code)

Prior Law

The Tax Reform Act of 1976 prevented the tax-free reorganization of certain investment companies. Exceptions were applied for stock in RICs, REITs and diversified investment companies.

Explanation of Provision

The Act provides that the stock of a RIC, REIT or diversified investment company will not be treated as stock of a single issuer for purposes of determining whether the holder is diversified within the meaning of section 368(a)(2)(F)(ii). This provision is intended to permit an investment company to be treated as a diversified investment company only if it would be so defined if it were deemed to own its ratable share of the assets of any RIC, REIT, or diversified investment company in which it owns stock (without regard to whether its percentage ownership is 50 percent or more).[2] The provision is effective as if included in the Tax Reform Act of 1976.

[2] A technical correction may be necessary to achieve this result.

10. Subchapter S amendments (sec. 1879(m) of the Act and secs. 1361 and 1368 of the Code)

Prior Law

The Subchapter S Revision Act of 1982 revised the treatment of S corporations. Rules were provided allowing certain trusts as shareholders and also rules were provided for the tax-free distributions of subchapter S earnings.

Explanation of Provision

The Act provides that shares which are treated as separate trusts within the meaning of section 663(c) are treated as separate trusts for purposes of the rules relating to qualified subchapter S trusts (sec. 1361(d)(3)).

The Act also provides that the accumulated adjustments accounts (which measures the amount of subchapter S earnings which may be distributed tax-free) will not be reduced by reason of federal taxes arising while the corporation was a C corporation.

These provisions will apply to taxable years beginning after December 31, 1982.

11. Qualified terminable interest property (sec. 1879(n)) of the Act and sec. 2523 of the Code)

Prior Law

Prior law allows a gift tax deduction for gifts of certain life estates made to a donee spouse. The election must be made by April 15 after the calendar year the interest in transferred.

Explanation of Provision

The Act provides that this election must be made on or before the date, including extensions, prescribed by section 6075 for filing a gift tax return with respect to the year in which the transfer was made.

The provision applies to transfers made after December 31, 1985. A specified transitional rule is provided.

12. Windfall profit tax (sec. 1879(n) of the Act and sec.4991 of the Code)

Prior Law

The windfall profit tax provides an exemption for oil held by certain charitable organizations.

Explanation of Provision

The Act provides that the exemption for "qualified charitable interests" includes an interest held by the Episcopal Royalty Company.

13. Certain transfers of property subject to restrictions (sec. 1879(p) of the Act and sec. 252 of ERTA)

Prior Law

The Economic Recovery Tax Act of 1981 provided that stock subject to the restrictions of section 16(b) of the Securities Exchange Act of 1934 is treated as being subject to a substantial risk of forfeiture and nontransferable for the six month period following receipt of the stock during which that section applies. Thus, unless the taxpayer elects (under sec. 83(b)) to be taxed when the stock is received, the taxpayer must include in income (and the employer may deduct), at the expiration of the period during which section 16(b) is applicable, the value of the stock at such time, less any amount the taxpayer paid for the stock.

Explanation of Provision

The Act permits certain individuals who received stock in 1973 pursuant to the exercise of employee stock options to elect to have section 252 of the Economic Recovery Stock Act of 1981 apply retroactively (i.e., with respect to transfers before December 31, 1981) in certain limited circumstances. Under the Act, any reduction in tax pursuant to such election could not exceed $100,000 with respect to any one employee. The statute of limitations is amended by the Act to permit refunds or credits, or assessments, attributable to the provisions of the Act.

14. Treatment of stripped tax-exempt bonds (sec. 1879(s) of the Act and sec. 1286(d) of the Code)

Prior Law

Under prior (and present) law, if coupons were detached ("stripped") from a taxable bond, the seller of the stripped bond or coupons was required to allocate the basis of the bonds with coupons attached between the components retained and those disposed of based on their relative fair market values. The purchaser, and the person stripping the bond to the extent he retained components, were required to accrue currently original issue discount under section 1272 with respect to the purchased (retained) components to the extent the stated redemption price at maturity exceeded the bond's or coupon's basis (sec. 1286).

Similarly, in the case of a stripped tax-exempt bond, both the person stripping the bond and the purchaser were required under prior (and present) law to allocate basis between the bond and the coupons. However, stripped tax-exempt bonds and coupons were not subject to the periodic income inclusion rules; thus, there was no current inclusion of original issue discount. Gain realized on the sale or redemption of the stripped tax-exempt bond was taxable as ordinary income.

The tax treatment of the coupons stripped from a tax-exempt bond was uncertain under prior law.

Explanation of Provision

The Act clarifies the treatment of stripped bonds and coupons resulting from the strip of a tax-exempt obligation. Under the Act, in the case of a stripped tax-exempt bond or coupon stripped from a tax-exempt bond, tax-exempt original issue discount accrues in an amount not in excess of the amount that produces a yield to maturity equal to the lower of the coupon rate on the bond or the actual yield (based on the purchase price) of the stripped bond or coupon. Congress intended that if a taxpayer can establish the actual yield of the obligation (with all coupons attached) at the time of original issue, the taxpayer may elect to use such yield in lieu of the coupon rate for purposes of this computation. Original issue discount accruing under this provision is taken into account in determining the holder's adjusted basis in the instrument under section 1288(a).

In addition to clarifying the treatment of the purchaser of a stripped tax-exempt bond or coupon, the Act provides that the person who strips a tax-exempt obligation may increase his basis by the amount of interest accrued on the bond or coupon prior to disposition.

15. Special Social Security Treatment for Church Employees (sec. 1882 of the Act, sec. 2603 of the Deficit Reduction Act of 1984, secs. 1402 and 3121 of the Code and sec. 211 of the Social Security Act)

a. Application to members of certain religious faiths

Prior Law

The Deficit Reduction Act of 1984 allows a church or qualifying church-controlled organization to make a one-time election to exclude from the definition of employment, for purposes of FICA taxes, services performed in the employ of the church or organization. If an election is made to exclude services for FICA purposes, the employee is treated similarly to a self-employed person with respect to those services. Thus, the employee is liable for self-employment ("SECA") taxes on remuneration for such services. The amount of remuneration on which an employee of an electing organization is liable for SECA tax is generally the same as the amount which would have been subject to FICA tax in the absence of an election.

Under section 1402(g) of the Code, an exemption from SECA taxes is provided for self-employed members of a religious sect (e.g., the Amish) who are adherents of established tenets or teachings of that sect, by reason of which such individuals are conscientiously opposed to public or private death, retirement, or medical insurance (including social security). This exemption is not available to employees. This exemption is granted only upon application by the individual, which must include evidence of the sect's tenets or teachings and of the individual's adherence to them. To obtain an exemption, the individual must waive all social security benefits.

Explanation of Provision

The Act makes clear that the exception from SECA taxes for members of certain religious faiths (sec. 1402(g)) is not available for services with respect to which SECA tax is due as a result of an election under the Act. Thus, if a member of a religious faith covered by the sec. 1402(g) exception is an employee of a church or church-controlled organization, and that church or organization elects to treat the employee as self-employed for FICA tax purposes, the employee cannot also claim a section 1402(g) exception from SECA taxes with respect to those services. This provision prevents the combination of an election under the Act, and a section 1402(g) exception, from resulting in an avoidance of any employment taxes on the services performed for the electing organization. This is consistent with the general principle that the tax for services covered by an election should be determined (to the extent possible) as it would be under FICA, for which the section 1402(g) exception would be unavailable. The provision does not affect the individual's ability to claim a section 1402(g) exception with respect to other services not covered by an election under the Act.

b. Computation of income subject to SECA tax

Prior Law

Under DEFRA, the remuneration on which the employee of an electing church or organization is liable for SECA tax generally is the same as the amount which would have been subject to FICA tax if that individual had continued to be treated as an employee. Thus, trade or business expenses are not subtracted in computing self-employment income (reimbursed business expenses are not included in self-employment income, however), and the $400 threshold generally applicable to self-employment income does not apply. Similarly, a $100 threshold (per employer) for a taxable year applies in determining whether remuneration for services covered by an election is subject to SECA tax. However, after 1989 these employees will be eligible for a deduction, in computing SECA taxes, for the product of net earnings from self-employment and one-half of the SECA rate.

Explanation of Provision

The Act provides several changes to insure that church employee income will be determined, as far as possible, using FICA principles, and that the taxation of other self-employment income will not be affected by an election. Specifically, the Act specifies that the SECA tax base for services covered by an election is to be computed in a separate "basket" from the tax base for other self-employment income. Thus, church employee income is not reduced by any deduction, while other income and deductions are not affected by items attributable to church employee income.[3] (This rule does

[3] The "optional" method of computing self-employment income applies only to non-church employee income.
This provision is effective only for remuneration paid or derived in taxable years beginning on or after January 1, 1986.

not apply to the deduction for the product of all net self-employment earnings and one-half the SECA tax rate, beginning after 1989). Additionally, the $100 threshold for taxing church employee income, and the $400 threshold applicable to other self-employment income, are separately applied under the Act (i.e., church employee income does not count toward the general $400 threshold).

c. Voluntary revocation of election

Prior Law

Under DEFRA, a church or organization must make an election to treat services performed for the church or organization as subject to SECA (rather than FICA) taxes before its first quarterly employment tax return is due, or if later, 90 days after July 18, 1984. Once made, that election may not be revoked by the church or organization. However, an election is to be permanently revoked by the Treasury Department if the electing church or organization fails to provide required information regarding its employees for a period of two years or more and, upon request by the Treasury Department, fails to furnish previously unfurnished information for the period covered by the election. (This information is required in order to monitor compliance with the provisions of DEFRA.) This rule could allow an electing church or organization effectively to revoke its election by failing to provide the required information.

Explanation of Provision

The Act allows a church or organization to revoke an election under regulations to be prescribed by the Treasury Department. The Act does not amend the rules allowing the Treasury Department to revoke an election for failure to provide required information. A church or organization which revokes an election (or for which the election is revoked) cannot make another election, because the time for making such an election has lapsed.

16. Extension of time for filing credit or refund with respect to the minimum tax (sec. 1896 of the Act)

Prior Law

The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) provided that certain transfers by insolvent farmers did not give rise to a minimum tax preference. This provision was effective for taxable years beginning after December 31, 1981.

Explanation of Provision

The Act provides that a claim for refund or credit resulting from the amendment made by COBRA may be filed within one year after October 22, 1986 (the date of enactment of the 1986 Act).

17. Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA): continuing health care provision (sec. 1895(d) of the Act, sec. 162(k) of the Code, secs. 602, 605, 606, and 607 of the Employee Retirement Security Act of 1974 (ERISA), and secs. 2202, 2205, and 2206 of the Public Health Service Act (PHSA))

Prior Law

COBRA amended the Code to add requirements relating to the provision by employers of continuing health care. In general, COBRA required that employers provide certain qualified beneficiaries—generally, employees and their spouses and dependent children—with the opportunity to continue to participate for a specified period in the employer's health plan despite the occurrence of a "qualifying event" that otherwise would have terminated such participation. The employer may require the qualified beneficiary to pay for the continued coverage under the plan.

The qualifying events that may trigger rights to continuation coverage are (1) the death of the employee; (2) the termination of the employee's employment (other than by reason of gross misconduct); (3) a reduction of the employee's hours; (4) the divorce or legal separation of the employee; (5) the employee becoming entitled to benefits under Medicare; and (6) a dependent child of the employee ceasing to be a dependent under the employer's plan. The maximum period of continuation coverage that may be elected is 36 months, except in the case of termination of employment or reduction of hours for which the maximum period is 18 months. However, certain events, such as the failure by the qualified beneficiary to pay the required premium may trigger an earlier cessation of the continuation coverage.

A qualified beneficiary has a prescribed period of time after a qualifying event in which to elect continuation coverage. However, such period does not commence until the employee receives notice from the plan administrator of the right to continuation coverage. In the case of a divorce or legal separation or a dependent child ceasing to be a dependent under the plan, the employee or qualified beneficiary is required to notify the plan administrator of the qualifying event, but the Act does not provide a time limit within which such notice is to be provided.

Explanation of Provision

Notification requirement

Under the Act, the notice required with respect to a divorce, legal separation, or a dependent child ceasing to be a dependent child under the plan, is to be provided by the employee or qualified beneficiary to the plan administrator within 60 days of such event. This 60-day notice requirement applies with respect to qualifying events occurring after October 22, 1986.

Maximum period of continuation coverage

The Act clarifies that there may be more than 1 qualifying event with respect to a qualified beneficiary that entitles the beneficiary to continuation coverage with respect to 1 employer, but the coverage period with respect to such events generally is not required to exceed 36 months. Thus, if a second qualifying event (such as death or divorce of the covered employee) occurs during the 18-month period of continuation coverage attributable to a termination of employment or reduction of hours, the qualified beneficiaries with respect to whom the second event occurred have a maximum continuation coverage period of 36 months from the date of termination or reduction. Congress did not intend this clarification to affect the application of the continuation coverage requirements to continuation coverage provided without regard to such requirements (e.g., retiree coverage). Thus, for example, if a married employee separates from service and, at such time, declines continuation coverage and elects coverage for his spouse and himself under an employer-paid retiree plan, and subsequently dies while covered by such plan, his surviving spouse will be a qualified beneficiary entitled to 36 months of beneficiary-paid continuation coverage under the retiree plan.

Election of coverage

The Act clarifies that each qualified beneficiary is entitled to a separate election of continuation coverage. For example, if a covered employee does not elect continuation coverage, Congress intended that the spouse or dependent children are entitled to elect such coverage. Moreover, even if the employee elects certain coverage, the spouse or dependents may elect different coverage. Thus, for example, if 1 family member elects core-only continuation coverage (i.e., coverage only for core benefits), the remaining qualified beneficiaries in the family unit are not bound by such election. Of course, to the extent qualified beneficiaries in a single family unit elect different continuation coverage, the family may no longer be entitled to pay the premium charge applicable to a single family. (For example, if a family of 4 elected core-only continuation coverage, they would be entitled to a single family rate; however, if 2 members elected core-only continuation coverage and 2 other members elected core plus noncore (such as dental or vision care) continuation coverage, the plan could charge each 2-member group a separate family rate.)

Failure to pay premium

The Act provides that the grace period for the failure by a qualified beneficiary to pay a premium for continuation coverage is the longest of (1) 30 days, (2) the period the plan allows active employees for failure to pay premiums, or (3) the period the insurance company (or other carrier or provider) allows the plan or the employer for failure to pay premiums.

Type of coverage

The Act provides that, except as otherwise provided by the Secretary in order to carry out the intent of the continuation coverage requirements, qualified beneficiaries are to be treated under the plan in the same manner as similarly situated beneficiaries for whom a qualifying event has not taken place. For example, if the plan provides for an open enrollment period, qualified beneficiaries are to be permitted to make elections during the open enrollment period in the same manner as active employees. Such open enrollment period is to be available not only to qualified beneficiaries who are former employees but, under the exception noted above, to each individual who is a qualified beneficiary by reason of being a spouse or dependent child of a covered employee. Such individuals are to have the same rights as active employees and are not to be limited to the rights of spouses or dependent children of active employees.

A second rule also falls within the exception noted above. Under this rule, Congress intended that an employer could not compel a qualified beneficiary to pay for noncore coverage in order to take continuation coverage with respect to core benefits. This rule is to apply even if active employees are required to purchase (or simply receive) both core and noncore benefits as part of a single group of benefits, without an option to purchase different elements separately. The exception does not apply, however, in the reverse situation: if active employees are required to purchase (or simply receive) both core and noncore benefits as part of a single group of benefits, a qualified beneficiary could be precluded from taking the noncore benefits without also taking the core benefits.

Also, under the Act, the continuation coverage requirements apply to group health plans, which term includes, for example, plans providing dental or vision care (within the meaning of medical care, as defined in section 213(d)).

Aggregation of employees

Under the Act, the rules aggregating related employers and the employee leasing rules apply to the continuation coverage requirements. This provision applies for years beginning after 1986.[4]

Nonresident aliens

The Act provides that an individual may not become a qualified beneficiary by virtue of being, or being related to, a nonresident alien who received no earned income (within the meaning of sec. 911(d)(2)) from the employer which constituted income from sources within the United States (within the meaning of sec. 861(a)(3)).

[4] A technical correction may be needed so that the statute reflects this intent. A correction that reflected part of this intent was included in the versions of H. Con Res. 395 which passed the House and Senate in the 99th Congress.

III. TECHNICAL CORRECTIONS TO THE RETIREMENT EQUITY ACT OF 1984

A. Minimum Participation, Vesting, and Benefit Accrual Standards (Sec. 1897(a) of the Act, sec. 203(c) of ERISA, and secs. 402 and 411 of the Code) [1]

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law (Code sec. 401(a)), then the plan is accorded special tax treatment. With respect to such a qualified plan, (1) a trust under the plan generally is exempt from Federal income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump-sum distribution may be accorded special long-term capital gain or income averaging treatment, and (4) certain plan distributions may be rolled over, tax-free, to an individual retirement arrangement (IRA) or to another qualified plan.

Under a pension plan (including a profit-sharing or stock bonus plan), benefits are provided to plan participants under formulas that determine the benefit a participant may earn, the portion of that benefit that has been earned, and the portion of the earned benefit that is nonforfeitable. Accordingly, such plans provide rules for determining whether an employee is a plan participant (the participation rules), for determining the portion of the benefit that has been earned (the benefit accrual rules), and for determining the nonforfeitable percentage of a participant's accrued benefit (the vesting schedule).

Under prior and present law, a pension plan must satisfy certain minimum standards relating to (1) the conditions under which employees may be excluded from plan participation, (2) the rate at which plan benefits are accrued, and (3) the rate at which benefits become nonforfeitable. The participation standards limit exclusions based on the age and number of years of service completed by an employee.[2] The benefit accrual standards are based on the number of years of plan participation. The vesting standard generally is based on the number of years of service with the employer completed by the employee.

[1] References to ERISA mean the Employee Retirement Income Security Act of 1974, and references to the Code mean the Internal Revenue Code of 1986.

[2] In addition, the Code provides participation rules for qualified plans. These rules are designed to require that qualified plans provide participation to a broad cross-section of employees.

1. Break-in-service rules

Prior Law

In general

Under prior and present law, all years of service with the employer maintaining a qualified plan are taken into account for purposes of determining (1) an employee's eligibility to participate in the plan, and (2) the portion of a participant's accrued benefit that is vested. No credit need be provided, however, for periods during which an employee is considered to have a break in service. In some cases, an employee who returns to work for an employer after a break in service may lose credit for service earned prior to the break in service.

Under the Retirement Equity Act of 1984 (REA), in the case of a nonvested participant, years of service completed with the employer or employers maintaining the plan before any period of consecutive 1-year breaks in service are required to be taken into account after a break in service, unless the number of consecutive 1-year breaks in service equals or exceeds the greater of (1) 5 years, or (2) the aggregate number of years of service before the consecutive 1-year breaks in service.

In addition, in the case of a participant in a defined contribution plan or in a defined benefit pension plan funded solely by certain insurance contracts, years of service after a break in service are not counted for purposes of determining the vested percentage of the participant's accrued benefit derived from employer contributions before the break in service, if the participant incurs at least 5 consecutive 1-year breaks in service.

Class-year vesting

In a class-year plan, employees' rights to benefits attributable to contributions made on their behalf with respect to any plan year are required to be nonforfeitable not later than the close of the fifth plan year following the plan year for which the contributions were made. A class-year plan is a profit-sharing, stock bonus, or money purchase pension plan that provides for the separate vesting of employee's rights to employer contributions with respect to each plan year.

Under REA, the application of the expanded break-in-service rules to class-year plans was not explicitly stated.

Lump-sum distributions

REA did not explicitly conform the expanded break-in-service rules with the rules relating to the taxation of lump-sum distributions. Under prior law, if an employee separated from service and received a distribution prior to the time at which the employee incurred 5 consecutive 1-year breaks in service, the potential increase in vesting that might occur if the employee returned to service could make the distribution ineligible for special income averaging tax treatment (Code sec. 402(e)).[3]

[3] See generally, Temp. Treas. Reg. sec. 11.401(e)(4)(A)-1(a).

Rollovers

A similar problem could occur if an employee separated from service and rolled over to an IRA or to another qualified plan any portion of a lump-sum distribution representing 100 percent of the employee's partially vested accrued benefit. If the employee returned to service with the employer before incurring 5 consecutive 1-year breaks in service, then the employee's prior rollover contribution could be treated as failing to meet the rollover requirements (Code sec. 402(a)(5)).

Elapsed time method of crediting service

Under prior and present law,[4] an alternative method of crediting service is provided under which an employer's rights with respect to plan participation, vesting, and benefit accrual are not based on the actual completion of a specified number of hours of service. This elapsed time method of crediting service is designed to lessen the administrative burdens of recordkeeping.

Temporary Treasury regulations [5] have provided some guidance relating to the application of the maternity and paternity leave provisions of REA to plans using the elapsed time method, but the temporary regulations did not address the application of the break in service rules of REA to plans using the elapsed time method.

Explanation of Provisions

Class-year vesting

The Act generally conforms the break-in-service rules applicable to class-year plans to the break-in-service rules provided for other types of plans. Under the Act, a class-year plan generally is to provide that 100 percent of each participating employee's right to benefits derived from employer contributions for a plan year (the contribution year) is to be nonforfeitable as of the close of the fifth plan year of service (whether or not consecutive) with the employer following the contribution year. A plan year is a plan year of service with the employer if the participant has not separated from service with the employer as of the close of the year.

The Act provides that, if a participant incurs 5 consecutive 1-year breaks in service before the completion of 5 plan years of service with respect to a contribution year, then the plan may provide that the participant forfeits any right to or derived from the employer contributions for the contribution year.

The provision is effective for contributions made for plan years beginning after October 22, 1986, except that the provision is not effective with respect to a collectively bargained plan until the applicable effective date of REA for that plan.

Lump-sum distributions

The Act conforms the rules relating to the taxation of lump-sum distributions to the break-in-service rules. Under the Act, in determining whether any distribution payable on account of separation

[4] Treas. Reg. sec. 1.410(a)-7.

[5] Temp. Treas. Reg. sec. 1.410(a)-7T.

from service is a lump sum distribution, the balance to the credit of the employee is determined without taking into account any increase in vesting that could occur if the employee is reemployed by the employer.

Under the Act, however, if the employee is reemployed by the employer before the occurrence of 5 consecutive 1-year breaks in service and the nonforfeitable interest of the employee in the amount of the pre-break accrued benefit is thereby increased, then the reduction in tax attributable to the treatment of the distribution as a lump-sum distribution is to be recaptured as provided by Treasury regulations. Such a reduction in tax could occur on account of an election to use averaging with respect to a lump-sum distribution, the special treatment of net unrealized appreciation of employer securities (Code sec. 402(e)(4)(J)), or long-term capital gains treatment for a portion of a lump-sum distribution. In addition, if such a recapture is made, the participant's previous lump sum distribution election is not taken into account in determining whether the employee is eligible to make another such election.

Rollovers

The Act provides that, in determining whether a distribution to an employee on account of separation from service is eligible to be rolled over to another plan or to an IRA, the balance to the credit of the employee is determined without regard to any increased vesting that may occur if the employee returns to service with the employer. However, if (1) the employee excludes the distribution from income on account of a rollover, (2) the employee returns to service with the employer before incurring 5 consecutive 1-year breaks in service and (3) the vested percentage of benefits accrued before the separation from service is increased, then any subsequent distributions to the employee from the plan in which the increased vesting occurs are not eligible for income averaging or capital gains treatment.

The rule denying eligibility for forward averaging or capital gains treatment on subsequent distributions does not apply if the distribution that was rolled over was made without the consent of the participant (e.g., the amount distributed did not exceed $3,500).

Elapsed time method of crediting service

The Congress directs the Treasury Department to provide, within a reasonable period of time after October 22, 1986, additional guidance to taxpayers on the application of the break in service rules to plans that use the elapsed time method of crediting service. It is not intended that such guidance is to be limited to the issuance of regulations.

2. Mandatory employee contributions

Prior Law

Under prior and present law, a right to an accrued benefit derived from employer contributions under a qualified plan is not treated as forfeitable merely because the plan provides that, in the case of a participant who is not at least 50 percent vested in the accrued benefits derived from employer contributions, the accrued

benefit may be forfeited if the employee withdraws any portion of the mandatory contributions. Mandatory employee contributions mean amounts contributed to the plan by the employee that are required (1) as a condition of employment, (2) as a condition of participation in the plan, or (3) as a condition of obtaining benefits under the plan attributable to employer contributions.

The rule permitting the forfeiture of certain employer contributions does not apply unless the plan provides that any accrued benefit forfeited is restored upon repayment by the participant of the amount of mandatory contributions withdrawn, plus interest in the case of a defined benefit plan. Under prior law, in the case of a defined contribution plan, the plan could provide that such repayment must be made before the participant had a single 1-year break in service after the withdrawal.

Under prior and present law, a similar rule permits certain service to be disregarded if attributable to amounts distributed to the employee on account of a separation from service. This rule applies for purposes of determining the period of an employee's service in calculating accrued benefits under a plan, but does not permit prior service to be disregarded until the employee has at least 5 consecutive 1-year breaks in service.

Explanation of Provision

The Act conforms the rule relating to the period for repayment of mandatory contributions to the rule relating to the repayment of accrued benefits after separation from service and extends both rules to apply in the case of a defined benefit plan as well as a defined contribution plan. The provision clarifies that the repayment period during which a plan must permit an employee to repay mandatory contributions does not end before a participant has 5 consecutive 1-year breaks in service.

A plan may provide that repayment of withdrawn amounts is required to be made no later than (1) 5 years after the date of the withdrawal, or (2) in the case of a distribution on account of separation from service, the earlier of (a) 5 years after the date the individual is reemployed by the employer or (b) the date upon which the individual incurs 5 consecutive 1-year breaks in service.

3. Maximum age requirement

Prior Law

REA reduced from 25 to 21 the maximum age requirement that a qualified plan may impose as a condition of plan participation. Thus, under prior and present law, a qualified plan generally may not require, as a condition of participation, completion of more than 1 year of service or attainment of an age greater than 21 (whichever occurs later). REA did not lower the maximum age requirement applicable to simplified employee pensions (SEPs).

Explanation of Provision

Effective for plan years beginning after October 22, 1986, the Act reduces from 25 to 21 the maximum age requirement that a SEP may impose as a condition of plan participation. Thus, a SEP may not require, as a condition of participation, attainment of an age greater than 21 or the performance of service during more than 3 of the immediately preceding 5 calendar years (whichever occurs later).

B. Survivor Benefit Requirements (Sec. 1897(b) of the Act, sec. 205 of ERISA, and secs. 401 and 417 of the Code)

1. Coordination between qualified joint and survivor annuity and qualified preretirement survivor annuity

Prior Law

A pension plan (including certain profit-sharing or stock bonus plans) is generally required to provide survivor benefits to the spouse of a plan participant who survives the participant. In the case of a participant who retires under the plan, the participant's accrued benefit is to be paid in the form of a qualified joint and survivor annuity, unless the participant and the participant's spouse (if any) waive the joint and survivor annuity in favor of another form of benefit.

Prior and present law requires that, in the case of a vested participant who dies before the participant's annuity starting date, the participant's surviving spouse is to receive a qualified preretirement survivor annuity unless the benefit was previously waived by the participant with the spouse's consent. The participant's annuity starting date is defined as the first day of the first period for which an amount is received as an annuity, whether by reason of retirement or disability, under the plan.

It is unclear under prior law what survivor benefit provisions (i.e., the qualified joint and survivor annuity provisions or the qualified preretirement survivor annuity provisions) applied in the case of (1) a participant who retires or attains the normal retirement age under the plan, but dies prior to the participant's annuity starting date, and (2) a participant who receives a disability benefit under a plan.

Explanation of Provision

In general

The Act clarifies and coordinates the application of the qualified joint and survivor annuity and qualified preretirement survivor annuity provisions in the case of (1) an individual who dies before or after the annuity starting date, and (2) an individual who receives a disability benefit under a plan.

Coordination of preretirement survivor annuity and joint and survivor annuity

The Act provides that the survivor benefit payable to a participant's spouse is to be provided in the form of a qualified joint and survivor annuity if the participant does not die before the annuity starting date unless the benefit is waived in favor of another beneficiary and the spouse consents to the waiver. As under prior law, the qualified preretirement survivor annuity rules apply in the case of a death before the annuity starting date if the preretirement survivor annuity has not been waived.

Thus, if a participant dies after separation from service or attainment of normal retirement age, but prior to the participant's annuity starting date, the survivor benefit payable to the participant's spouse is to be paid in the form of a qualified preretirement survivor annuity.

Disability benefits

The Act amends the definition of a participant's annuity starting date to exclude the commencement of disability benefits, but only if the disability benefit is an auxiliary benefit. If a participant receiving a disability benefit will, upon attainment of early or normal retirement age, receive a benefit that satisfies the accrual and vesting rules of section 411 (without taking the disability benefit payments up to that date into account), the disability benefit may be characterized as auxiliary.

For example, consider a married participant who becomes disabled at age 45 with a deferred vested accrued benefit of $100 per month commencing at age 65 in the form of a joint and survivor annuity. If the participant is entitled under the plan to a disability benefit and is also entitled to a benefit of not less than $100 per month commencing at age 65, whether or not the participant is still disabled, the payments made to the participant between ages 45 and 65 would be considered auxiliary. Thus, the participant's annuity starting date would not occur until the participant attained age 65. The participant's surviving spouse would be entitled to receive a qualified preretirement survivor annuity if the participant died before age 65, and the survivor portion of a qualified joint and survivor annuity if the participant died after age 65. The value of the qualified preretirement survivor annuity payable upon the participant's death prior to age 65 is computed by reference to the qualified joint and survivor annuity that would have been payable had the participant survived to age 65.

If, in the above example, the participant's benefit payable at age 65 were reduced to $90 per month as a result of the disability benefits paid to the participant prior to age 65, the disability benefit would not be auxiliary. The benefit of $90 per month payable at age 65 would not, without taking into account the disability benefit payments prior to age 65, satisfy the minimum vesting and accrual rules of section 411 of the Code. Accordingly, the first day of the first period for which the disability payments are made constitute the participant's annuity starting date, and any benefits paid to the participant are required to be paid in the form of a qualified joint and survivor annuity (unless waived by the participant with the consent of the spouse).

2. Transferee plan rules

Prior Law

The provisions of prior and present law relating to survivor benefits generally apply to any pension plan. However, the survivor benefit requirements do not apply with respect to a participant

under a profit-sharing or stock bonus plan if (1) the plan provides that the nonforfeitable accrued benefits of a deceased participant will be paid to the surviving spouse of the participant (or to another beneficiary if the surviving spouse consents or if there is no surviving spouse), (2) under a plan that provides for benefits in the form of a life annuity, the participant does not elect payment of benefits in the form of a life annuity, and (3) with respect to the participant, the plan is not a direct or indirect transferee of a plan required to provide survivor benefits.

A plan is a transferee of a plan required to provide survivor benefits if the plan (1) receives a direct transfer of assets in connection with a merger, spinoff, or conversion of a plan that is subject to the survivor benefit requirements, or (2) receives a direct transfer of assets solely with respect to the participant. Also, a plan is a transferee plan with respect to a participant if it receives amounts from a plan that is a transferee plan with respect to that participant. A plan is not a transferee plan merely because it receives rollover contributions from another plan. The transferee plan rules do not apply in the case of a rollover contribution because the consent of the participant's spouse had to be obtained in order to make the plan distribution that qualified for rollover treatment.

Explanation of Provision

The Act includes two provisions relating to the transferee plan rules. First, the Act clarifies that a plan is not to be considered a transferee plan on account of a transfer completed before January 1, 1985.

In addition, the Act clarifies that the transferee plan rule is limited to benefits attributable to the transferred assets if separate accounting is provided for the transferred assets and the allocable investment yield from those assets. Under the Act, if separate accounting is not maintained for transferred assets (and any allocable investment yield) with respect to an employee, then the survivor benefit requirements apply to all benefits payable with respect to the employee under the plan.

3. Rules relating to qualified preretirement survivor annuity

Prior Law

Under prior and present law, a qualified preretirement survivor annuity is defined as an annuity for the life of the surviving spouse of the participant. The amount of each payment under a qualified preretirement survivor annuity is not to be less than the payment that would have been made under a qualified joint and survivor annuity if (1) in the case of a participant who dies after attaining the earliest retirement age under the plan, the participant had retired with an immediate qualified joint and survivor annuity on the day before the participant's death, and (2) in the case of a participant who dies on or before the earliest retirement age under the plan, the participant had separated from service on the date of death, survived until the earliest retirement age, and retired at that time with a qualified joint and survivor annuity. Under prior law, the term "earliest retirement age" was defined as the earliest date on which, under the plan, the participant could elect to receive retirement benefits.

Under a special rule for defined contribution plans that are subject to the survivor benefit requirements, the term "qualified preretirement survivor annuity" is defined as an annuity for the life of the surviving spouse the actuarial equivalent of which is not less than 50 percent of the account balance of the participant as of the date of death.

A plan may permit a surviving spouse to elect to have survivor benefits paid in a form other than an annuity, but only if the value of the alternative form of benefits is not less than the actuarial equivalent of the required survivor benefit.

For purposes of the survivor benefit requirements, a vested participant is any participant (whether or not still employed by the employer at the time of death) who has a nonforfeitable right to any portion of the accrued benefit under the plan derived from employer contributions.

Under prior and present law, a plan that is subject to the survivor benefit requirements may nevertheless provide that a joint and survivor annuity or a qualified preretirement survivor annuity will not be paid unless the participant and spouse have been married throughout the 1-year period ending on the earlier of the participant's annuity starting date, or the date of the participant's death. However, in the case of a plan that is exempt from the survivor benefit requirements, because the plan provides that the nonforfeitable accrued benefits of a deceased participant will be paid to the surviving spouse of the participant, prior law was unclear as to whether the plan could provide for the payment of the participant's nonforfeitable accrued benefit (without the consent of the surviving spouse) to a beneficiary other than the surviving spouse, unless the participant and surviving spouse had been married at least 1 year as of the death of the participant.

Explanation of Provisions

The Act clarifies that, in the case of a participant who separates from service prior to death, the amount of the qualified preretirement survivor annuity is to be calculated by reference to the actual date of separation from service, rather than the date of death. Thus, for purposes of calculating the qualified preretirement survivor annuity, a participant is not considered to accrue benefits after the date of separation from service.

The Act also clarifies that, under the special rule for defined contribution plans, a qualified preretirement survivor annuity payable to a participant's surviving spouse is required to be the actuarial equivalent of not less than 50 percent of the account balance in which the participant was vested as of the date of death. For purposes of determining who is a vested participant subject to the survivor benefit provisions, the Act provides that a participant's accrued benefit includes accrued benefits derived from employee contributions.

The Act also clarifies that a plan that is exempt from the survivor benefit provisions may provide for the payment of the participant's nonforfeitable accrued benefit (without the consent of the participant's surviving spouse) to a beneficiary other than the participant's spouse if the participant and spouse have been married for less than 1 year as of the death of the participant.

The Congress is aware that questions have arisen concerning the definition of a participant's "earliest retirement age." The Congress intends that a participant's "earliest retirement age" should be determined by taking in account only the participant's actual years of service at the time of the participant's separation from service or death. Thus, in the case of a plan under which participants may not receive a benefit under the plan until the participant attains age 65, or upon attainment of age 55 and completion of 10 years of service, the earliest retirement age of a participant who died or separated from service with only 8 years of service would be age 65. On the other hand, if a participant died or separated from service after completing 10 years of service, the earliest retirement age would occur when the participant would have attained age 55 (if the participant had survived).

4. Spousal consent requirements

Prior Law

Under prior and present law, the consent of a participant's spouse is required for an election to waive the qualified joint and survivor annuity or the qualified preretirement survivor annuity. This consent is to be given in writing at the time of the participant's election, and the consent is to acknowledge the effect of the election. A consent is not valid unless it is witnessed by a plan representative or a notary public. Any consent obtained is effective only with respect to the spouse who signs it.

Spousal consent to a waiver is not required if it is established to the satisfaction of a plan representative that there is no spouse because the spouse cannot be located, or because of such other circumstances as the Secretary of the Treasury may by regulations prescribe.

A spouse's consent to waive a death benefit under a profit-sharing or stock bonus plan not otherwise subject to the survivor benefit requirements is to be made in the same manner as the spousal consent to waive a qualified joint and survivor annuity or a qualified preretirement survivor annuity. REA did not require spousal consent under an exempt profit-sharing or stock bonus plan to be made at the same time as spousal consent under a plan subject to the survivor benefit requirements. Thus, REA generally did not require that spousal consent be obtained to make a distribution, such as an in-service withdrawal, to a participant under a profit-sharing or stock bonus plan not subject to section 401(a)(11).

A plan may immediately distribute the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity if the present value of the benefit does not exceed $3,500. An accrued benefit is immediately distributable if any part of the benefit may be distributed to the participant before the later of the normal retirement age or age 62.

No "cash-out" may be made after the annuity starting date unless the participant and the participant's spouse (or the surviving spouse of the participant) consent in writing to the distribution.

Thus, a plan could permit a participant and the participant's spouse (or a participant's spouse) to change the form of benefits received under the plan after the annuity starting date.

In addition, if the present value of the benefit under the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, then the consent of the participant and spouse (or the surviving spouse if the participant has died) must be obtained before the plan can immediately distribute any part of the present value in a form other than a qualified joint and survivor annuity or a qualified preretirement survivor annuity.

Prior and present law does not preclude a plan from permitting a spouse to make a conditional waiver of a survivor benefit. For example, a plan could offer a spouse the right to waive a qualified preretirement survivor annuity, effective only if the present value of the annuity is less than another death benefit payable to the spouse under the plan.

Under prior law, it was unclear whether the waiver of a qualified joint and survivor annuity or a qualified preretirement survivor annuity by a nonparticipant spouse was a taxable transfer for purposes of the gift tax provisions.

Explanation of Provisions

Designation of nonspouse beneficiary

Under the Act, a spouse's consent to waive a qualified joint and survivor annuity or a qualified preretirement survivor annuity is not valid unless the consent (1) names a designated beneficiary who will receive any survivor benefits under the plan and the form of any benefits paid under the plan (including the form of benefits that the designated beneficiary will receive), or (2) acknowledges that the spouse has the right to limit consent only to a specific beneficiary or a specific form of benefits, and that the spouse voluntarily elects to relinquish one or both of such rights.

The spousal consent form is to contain such information as may be appropriate to disclose to the spouse the rights that are relinquished. If the consent names a designated beneficiary, then any subsequent change to the beneficiary designation (or the form of distribution, if any, specified in the consent) is invalid unless a new consent is obtained from the participant's spouse. Of course, spousal consent is not required if a participant dies and the beneficiary designated (with spousal consent) to receive the participant's death benefit elects to receive the benefit in a form not specified in the waiver.

If a plan is required to permit the waiver of a survivor benefit, the Congress intends that the plan may not restrict the spouse's ability to waive a benefit by providing only a general consent to waive under which a spouse relinquishes the right to designate a beneficiary or a form of benefit. Thus, a spouse is always permitted to waive a survivor benefit only in favor of a specific beneficiary or a specific form of benefit. The Congress intends that, if a plan permits a general consent, the acknowledgment of the general consent should indicate that the spouse is aware that a more limited consent could be provided.

Similar rules relating to the manner in which spousal consent is obtained apply to a spousal consent obtained to waive a death benefit under a profit-sharing or stock bonus plan that is not otherwise subject to the survivor benefit requirements.

Spousal consent with respect to loans

In addition, under the Act, in the case of a participant's benefit that is not exempt from the survivor benefit requirements, a plan is to provide that no portion of the accrued benefit of the participant may be used as security for any loan unless, at the time the security agreement is entered into, the participant's spouse (determined as of the date the security agreement is entered into) consents to the use of the accrued benefit as security. If the individual who is the participant's spouse at the time that the security agreement is entered into consents, then the plan is not prevented by the spousal consent rules from realizing its security interest in the event of a default on the participant's loan, even if, at the time of the default, the participant is married to a different spouse. Similarly, if a participant is not married at time the security agreement is executed, then the plan is not prevented from realizing its security interest if a default on the loan subsequently occurs when the participant is married.

For example, assume that a spouse consents to a pledge of the participant's account balance as security for a loan from the plan. Under the plan, the plan administrator is to realize on the security for the loan if it is not repaid by the time the employee separates from service. Because the spouse consented to the loan, the plan is not prevented from using the security (i.e., the account balance) to recover the amount due on the loan. In addition, if the participant had remarried after the loan was made but before the plan realized on its security, then the consent of the first spouse would continue to be effective for purposes of determining the plan's ability to realize its security interest.

In the case of a participant whose accrued benefit is not subject to the survivor benefit provisions at the time the security is provided (e.g., a profit-sharing plan that is not a transferee plan with respect to the participant), the plan will not be treated as failing to meet the survivor benefit requirements if the participant's benefit is used as security for a loan and spousal consent is not obtained for the use of the accrued benefit as security, even if the plan subsequently becomes subject to the survivor benefit requirements with respect to the participant.

The Act further clarifies that for purposes of determining the survivor benefit, if any, to which a participant's surviving spouse is entitled upon the participant's death, any security interest held by the plan by reason of a loan outstanding to the participant is taken into account and, if there is a default on the loan, then the participant's nonforfeitable accrued benefit is first reduced by any security interest held by the plan by reason of a loan outstanding to the participant. The rule applies only if (a) the loan is secured by the participant's accrued benefit and (b) the spousal consent requirements, if any, applicable to the participant's accrued benefit at the time the security arrangement was entered into were satisfied. In addition, the participant's nonforfeitable accrued benefit is adjusted (where appropriate), taking into account the terms of the plan and the terms of the qualified domestic relations order, by the value of amounts payable under any outstanding qualified domestic relations order, for purposes of determining the survivor benefit, if any, to which the participant's surviving spouse is entitled upon the participant's death.

Similarly, upon a married participant's retirement, for purposes of determining the amount of the joint and survivor annuity payable to the participant and spouse, any security held by the plan by reason of a loan outstanding to the participant and the present value of any outstanding qualified domestic relations order are taken into account in the same manner as they are taken into account for purposes of the qualified preretirement survivor annuity.

Determination of amount of preretirement survivor annuity

The Act provides that, in the case of a defined contribution plan subject to the survivor benefit requirements, the participant's vested account balance (including any portion of the account balance attributable to employee contributions) is used for purposes of determining the amount of the qualified preretirement survivor annuity.

Scope of spousal consent requirements

The Act clarifies that certain of the election period and notice requirements with respect to spousal consent also apply in the case of spousal consent (1) to waive a survivor benefit under a plan exempt from the preretirement survivor annuity and joint and survivor annuity requirements, (2) to permit the participant's accrued benefit to be pledged as security for a loan, (3) to permit the election of a cash-out of amounts after the annuity starting date, and (4) to permit the immediate distribution of amounts in excess of $3,500.

In the case of a loan secured by a participant's accrued benefits, the notice and election period requirements apply at the time the security arrangement is entered into. Consequently, the election period for spousal consent with respect to the execution of a security agreement is the 90-day period before the execution of the agreement.

Similarly, in the case of a cash out subsequent to a participant's annuity starting date, the election period is the 90-day period before the distribution is permitted.

The Congress intends that, for purposes of the spousal consent rules, in the case of a participant residing outside of the United States, spousal consent may be witnessed by the equivalent of a notary public in the jurisdiction in which consent is executed. The Congress also intends that an election under section 242(b) of the Tax Equity and Fiscal Responsibility Act of 1982 will not be invalidated because a plan secures spousal consent to the election.

In addition, the Congress intends that a participant will be treated as having no spouse, if the participant has been abandoned (within the meaning of local law) by the spouse, even if the participant knows where the spouse is located. The Congress intends that the spousal consent requirement may be waived, however, only if the participant has a court order specifying that the participant

has been abandoned within the meaning of local law. Of course, a participant could provide a qualified domestic relations order specifying that the participant has been abandoned.

Gift tax consequences of waiver

The Act provides that the waiver of a qualified joint and survivor annuity or a qualified preretirement survivor annuity by a nonparticipant spouse prior to the death of the participant does not result in a taxable transfer for purposes of the gift tax provisions.

Effective dates

The provision relating to spousal consents to beneficiary designations is effective for plan years beginning after October 22, 1986. The provision relating to the notice and election period requirements for plans that are exempt from the survivor benefit requirements is effective on October 22, 1986.

The provision relating to accrued benefits pledged as security for a loan is effective for loans made after August 18, 1985. In addition, any accrued benefits pledged as security for a loan prior to August 19, 1985, are exempt from the requirement that spousal consent be obtained. Accordingly, in the case of a pledge made before August 19, 1985, a plan is not required to obtain the consent of any spouse of a participant before it applies the benefit against the loan. Finally, any loan that is revised, extended, renewed, or renegotiated after August 18, 1985, is treated as a loan made (and security pledged) after August 18, 1985.

5. Notice requirement

Prior Law

Under prior and present law, a plan is required to notify participants of their rights to decline a qualified preretirement survivor annuity before the applicable election period. This notice is to be provided within the period beginning on the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which the participant attains age 35. This notice is to be comparable to the notice required with respect to the qualified joint and survivor annuity. The qualified preretirement survivor benefit coverage may become automatic prior to the time that the participant is entitled to decline such coverage.

Explanation of Provision

The Act provides that the period during which notice is required to be provided to an individual does not end before the latest of (1) the close of the plan year in which a participant attains age 35; (2) a reasonable period of time after the individual becomes a plan participant; (3) a reasonable period of time after the survivor benefit applicable to a participant is no longer subsidized (as defined in Code sec. 417(a)(4)); or (4) a reasonable period of time after the survivor benefit provisions (Code sec. 401(a)(11)) become applicable with respect to a participant.

The Act also provides that, if a participant separates from service prior to age 35, the plan must provide the participant with notice, within a reasonable time after separation from service, of the right to decline a qualified preretirement survivor annuity.

6. Clarification of rule for subsidized benefits

Prior Law

Under prior and present law, a plan is not required to provide notice of the right to waive the qualified joint and survivor annuity or the qualified preretirement survivor annuity if the plan fully subsidizes the cost of the benefit. A plan fully subsidizes the cost of a benefit only if the failure to waive the benefit by a plan participant does not result in either (1) a decrease in any plan benefits with respect to the participant, or (2) increased plan contributions by the participant.

Explanation of Provision

The Act clarifies that a plan is not required to provide a participant with a right to waive a qualified joint and survivor annuity or qualified preretirement survivor annuity if the plan fully subsidizes the cost of the benefit.

The Act further clarifies that the exception to the notice requirement only applies if (1) the plan fully subsidizes the benefit, and (2) the plan does not permit a participant to waive the benefit or to designate another beneficiary.

The Congress intends that a benefit is not considered fully subsidized if the cost of the survivor benefit is spread among all plan participants, including participants who are not married, or among some subgroup of participants, even if the benefits and contributions of those charged with the cost of survivor benefit protection are unaffected by the waiver or failure to waive survivor benefit protection. Of course, if a participant is not entitled to waive a survivor benefit, the participant cannot be charged for the benefit.

7. Clarification of annuity starting date

Prior Law

Prior and present law provides that the annuity starting date means the first period for which an amount is received as an annuity (whether by reason of death or disability).

Explanation of Provision

Under the Act, in the case of benefits payable in the form of an annuity, the annuity starting date is the first day of the first period for which an amount is payable as an annuity, regardless of when or whether payment is actually made. For example, assume that a participant is to begin receiving payments on the first day of the month following the participant's sixtieth birthday. After that date, but before any annuity payments are actually made, the participant dies. The annuity starting date is the first day of the month following the participant's sixtieth birthday.

Under the Act, in the case of benefits not payable as an annuity, the annuity starting date is the date on which all events have occurred which entitle the participant to a benefit (e.g., separation from service or applicable consent to payment).

C. Qualified Domestic Relations Orders (Sec. 1897(c) of the bill, sec. 206 of ERISA, and secs. 502 and 414(p) of the Code)

Under prior and present law, neither ERISA nor the Code treats a qualified domestic relations order as a prohibited assignment or alienation of benefits under a pension plan. In addition, REA created an exception to the ERISA preemption provision only with respect to these orders.

A "qualified domestic relations order" is a domestic relations order that (1) creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to receive all or a portion of the benefits payable with respect to a participant under a pension plan, and (2) meets certain other requirements. A domestic relations order is any judgment, decree, or order (including approval of a property settlement agreement) that relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of the participant, and is made pursuant to a State domestic relations law (including community property law).

An alternate payee includes any spouse, former spouse, child, or other dependent of a participant who is recognized by a qualified domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to the participant.

The qualified domestic relations order provisions do not prevent the payment of amounts in pay status with respect to an alternate payee to a State agency that is an agent of an alternate payee or the payment of such amounts if the alternate payee consents to such payment (for example, to meet the requirements relating to Aid to Families with Dependent Children). In such a case, payment to the agency does not result in disqualification of the order and, under normal principles of constructive receipt, the alternate payee is treated as having received the amounts paid under the order.

1. Tax treatment of divorce distributions

Prior Law

Special rules are provided under prior and present law for determining the tax treatment of benefits subject to a qualified domestic relations order. For purposes of determining the taxability of benefits, under prior law, the alternate payee was treated as a distributee with respect to payments received from or under a plan.

In addition, net employee contributions (together with other amounts treated as the participant's investment in the contract) are apportioned between the participant and the alternate payee under regulations prescribed by the Secretary of the Treasury.

Explanation of Provision

The Act provides that the special rules for determining the taxability of benefits subject to a qualified domestic relations order apply only to distributions made to an alternate payee who is the spouse or the former spouse of the participant. Thus, distributions to a spouse or former spouse generally will be included in the gross income of the spouse or former spouse. Under the Act, however, a distribution to an alternate payee other than a spouse (e.g., a child) is generally includible in the gross income of the participant. For purposes of lump sum treatment, amounts paid to an alternate payee other than a spouse, or former spouse, are treated as part of the balance to the credit of the participant.

In addition, under the Act, the rules for allocating an employee's investment in the contract between the employee and an alternate payee apply only if the alternate payee is a spouse or former spouse of the participant.

If the alternate payee is not a spouse or former spouse, then the investment in the contract is not allocated to the alternate payee and is recovered by the participant under the general basis recovery rules applicable to the participant.

2. Determination by plan administrator

Prior Law

Under prior and present law, to be a qualified order, a domestic relations order must clearly specify (1) the name and last known mailing address (if available) of the participant and the name and mailing address of each alternate payee to which the order relates, (2) the amount or percentage of the participant's benefits to be paid to an alternate payee or the manner in which the amount is to be determined, and (3) the number of payments or period for which payments are required. Subsequent vesting or benefit accruals of a participant are not taken into account in determining the amount payable to an alternate payee unless specifically provided under the domestic relations order.

A domestic relations order is not a qualified order if it (1) requires a plan to provide any type or form of benefit, or any option, not otherwise provided under the plan, (2) requires the plan to provide increased benefits, or (3) requires payment of benefits to an alternate payee that are required to be paid to another alternate payee under a previously existing qualified domestic relations order.

The administrator of a plan that receives a domestic relations order is required to notify promptly the participant and any other alternate payee of receipt of the order and the plan's procedures for determining whether the order is qualified. In addition, within a reasonable period after receipt of the order, the plan administrator is to determine whether the order is qualified and notify the participant and alternate payee of the determination.

During any period in which the issue of whether an order is a qualified order is being determined (by the plan administrator, by a court of competent jurisdiction, or otherwise), the plan administrator is to defer the payment of any benefits in dispute. These deferred benefits are segregated either in a separate account in the plan or in an escrow account. A plan administrator similarly could not permit a loan to be made to the participant during the period of deferral if the loan is to be secured by the benefits in dispute.

If the order is determined to be a qualified domestic relations order within 18 months after benefits are first deferred, then the plan administrator is to pay the segregated amounts to the persons entitled to receive them. If the plan administrator determines that the order is not a qualified order or, after the 18-month period has expired, the plan administrator has not resolved the issue of whether the order is qualified, the segregated amounts are paid to the person or persons who would have received the amounts if the order had not been issued.

Explanation of Provision

The Congress intends that an order will not fail to be a qualified domestic relations order even if the form of the benefit does not continue to be a form permitted under the plan on account of (1) a plan amendment or (2) a change of law. In the case of a plan amendment, an alternate payee remains entitled to receive benefits in the form specified in the order unless the alternate payee elects to receive benefits in another form and the election of such alternate form does not affect, in any way, the amount or form of benefits payable to the participant. In the case of a change of law, which makes the form specified in the order impermissible, the Congress intends that the plan is to permit the alternate payee to select a form of benefit specified in the plan, provided the selection of an alternative form by the alternate payee does not affect, in any way, the amount or form of benefits payable to the participant.

The Act makes it clear that the 18-month period during which benefits may be deferred begins with the date on which any payments would, but for the deferral, be required to commence. Accordingly, if a payment is deferred pending the resolution of a dispute, then that payment and each other payment that is deferred within the next 18 months because of the dispute are to be segregated. If the dispute is not resolved within 18 months after the first payment is deferred, then all payments deferred during the 18-month period with respect to the dispute are to be paid to the persons who would have received them if the order had not been issued.

If a plan administrator determines that a domestic relations order is defective before the expiration of the 18-month suspension period, the Congress intends that the plan administrator may delay payment of a participant's benefit until the expiration of the 18-month period if the plan administrator has notice that the parties are attempting to rectify any deficiencies in the order.

Notice of issuance of a stay during the time an appeal is pending is deemed to be notice that the parties are attempting to cure deficiencies in a domestic relations order. Further, the Congress intends that a plan administrator will honor a restraining order prohibiting the disposition of a participant's benefits pending resolution of a dispute with respect to a domestic relations order.

Similarly, Congress intended that the plan administrator may delay payment of benefits for a reasonable period of time if the plan administrator receives notice that a domestic relations order is being sought. For example, assume that a participant in a profit-sharing plan which is exempt from the survivor benefit rules requests a lump-sum distribution from the plan. Before the distribution is made, the plan administrator receives notice that the participant's spouse is seeking a domestic relations order. The plan administrator may delay payment of benefits.

In addition, the Act eliminates the requirement that a defined benefit plan establish an escrow account for amounts that would have otherwise been paid during the 18-month period. Instead, the plan administrator is required only to account separately for such amounts. If the deficiency is not cured or the dispute not resolved within the 18-month period, all payments deferred during the 18-month period are to be paid to the persons who would have received them if the stay or order had not been issued.

The Act does not change the requirement that the plan administrator is to determine whether the order is qualified and notify the participant and alternate payee of the determination within a reasonable period after the plan administrator receives the order.

3. Form of benefit

Prior Law

Under prior and present law, a qualified domestic relations order may not require that payments to an alternate payee be made, prior to the date that the participant separates from service, in the form of a joint and survivor annuity with respect to the alternate payee and his or her subsequent spouse. Prior law was not clear as to whether a plan that offers a joint and survivor annuity option may be required by a qualified domestic relations order to make payments subsequent to a participant's separation from service in the form of a joint and survivor annuity with respect to the alternate payee and his or her subsequent spouse.

Explanation of Provision

The Act clarifies that a qualified domestic relations order may not require that payments prior to, or subsequent to, a participant's separation from service be made in the form of a qualified joint and survivor annuity with respect to the alternate payee and his or her subsequent spouse.

4. Application of domestic relations provisions to plans not subject to assignment or alienation restrictions

Prior Law

Under prior law, it was unclear whether the rules relating to qualified domestic relations orders applied to plans, such as governmental plans (within the meaning of sec. 414(d) of the Code) that were not subject to the assignment or alienation restrictions of ERISA and the Code.

Explanation of Provision

The Act clarifies that the qualified domestic relations provisions do not apply to any plan to which the assignment or alienation restrictions do not apply. For example, a domestic relations order relating to the division of pension benefits of a participant in a plan maintained by a governmental employer is not required to meet the rules relating to qualified domestic relations orders because the payment of benefits to a spouse or former spouse of the participant is not a prohibited assignment or alienation of the participant's benefits.

5. Coordination of domestic relations provisions with Federal garnishment restrictions

Prior Law

Under prior law, it was unclear whether the payment of benefits pursuant to a qualified domestic relations order constituted a garnishment for purposes of Federal or State law restrictions on garnishment of wages.

Explanation of Provision

The Act clarifies that the payment of benefits pursuant to a qualified domestic relations order is not treated as a garnishment of wages for purposes of Federal or State law restrictions on garnishment.

6. Coordination with qualified plan requirements

Prior Law

Under prior and present law, a plan is not treated as failing to satisfy the requirements of Code section 401(a) or 401(k) that prohibit payment of benefits subsequent to the participant's attainment of the earliest retirement age under the plan, but prior to termination of employment or such time as distributions are otherwise permitted solely because the plan makes payments to the alternate payee in accordance with a qualified domestic relations order. However, under prior law, it was unclear whether payments made to an alternate payee pursuant to a qualified domestic relations order prior to the date at which the participant would have attained the earliest retirement age violated these qualification requirements.

Explanation of Provision

The Act makes it clear that a plan is not treated as failing to satisfy the qualification requirements of section 401 (a) or (k) or section 409(d) (prohibiting payment of benefits prior to termination of employment or such time as distributions are otherwise permitted) solely because the plan makes payment to the alternate payee, even if the payments are made with respect to a participant who has not separated from service, and they commence before the participant has attained the earliest retirement age under the plan. This exception applies, however, only if the present value of the

benefit to be paid to an alternate payee (1) does not exceed $3,500 or (2) exceeds at least $3,500 and the alternate payee consents in writing to such earlier distribution. Further, the exception applies only if the distribution, if paid to the participant, would not contravene the provisions of the plan (except as permitted under section 414(p)(4)). Of course, a plan may not make distributions to an alternate payee at a time not specified in a qualified domestic relations order unless (1) the order also provides for such earlier distributions pursuant to an agreement between the plan and an alternate payee, and (2) the plan authorizes such distributions.

In determining whether the present value of the benefit payable to the alternate payee exceeds $3,500, the present value of the participant's accrued benefit or that of any other alternate payee (after reduction for the benefits payable to the alternate payee) is disregarded. Similarly, for purposes of determining whether the present value of a benefit payable to a participant exceeds $3,500, the present value of amounts payable to an alternate payee under a qualified domestic relations order is disregarded.

The Act provides that, to the extent provided in a qualified domestic relations order, a spouse of a participant is not treated as a spouse. For example, a qualified domestic relations order could provide for the division of a participant's accrued benefits under a pension plan as part of a separation agreement and could further provide that the participant's spouse is not entitled to receive any survivor benefits under the usual survivor benefits provisions. Thus, the plan administrator would not be required to secure spousal consent to the participant's election to waive a survivor benefit.

In addition, the Act authorizes the Secretary of the Treasury to issue such regulations as may be necessary to otherwise coordinate the Code provisions affecting qualified domestic relations orders (secs. 401(a)(13)(B) and 414(p)), and the regulations issued by the Secretary of Labor thereunder with other Code provisions affecting qualified plans. The Secretary of Labor has authority to issue regulations under the qualified domestic relations order provisions of ERISA and the Code (secs. 401(a)(13)(B) and 414(p)), and the Act does not affect the authority of the Secretary of Labor to prescribe such regulations.

7. Earliest retirement age

Prior Law

Under prior and present law, a domestic relations order is not a qualified domestic relations order if such order requires a plan to provide any type or form of benefit, or any option, not otherwise provided under the plan. As an exception to the rule, prior and present law provides that a qualified domestic relations order may require that an alternate payee commence receiving payments on or after the date that the participant attains the earliest retirement age under the plan, even if the participant has not yet separated from service. For purposes of the qualified domestic relations order provisions, earliest retirement age under a defined contribution plan is defined as the date that is 10 years before the participant's normal retirement age. Under prior law, "earliest retirement age" under a defined benefit plan was defined in the same manner as the term was defined for purposes of the survivor benefit requirements of section 417. The term "earliest retirement age" was defined for purposes of the survivor benefit provisions as the earliest date on which, under the plan, the participant could elect to receive retirement benefits.

Explanation of Provision

The Act clarifies that, for purposes of the rules relating to qualified domestic relations orders, a participant's earliest retirement age under a defined benefit pension plan, as well as a defined contribution plan, is the earlier of (1) the date that the participant is entitled to a distribution under the plan or (2) the later of (i) the date the participant attains age 50 or (ii) the earliest date on which the participant could begin receiving benefits under the plan if the participant separated from service.

For example, in the case of a plan which provides for payment of benefits upon separation from service (but not before then), the earliest date on which a qualified domestic relations order can require payments to an alternate payee to begin is the date the participant separates from service, unless the plan provides for payment at an earlier time. A qualified domestic relations order could also require such a plan to begin payments to an alternate payee when the participant attains age 50, even if the participant has not then separated from service.

The amount payable under a qualified domestic relations order following the participant's earliest retirement age cannot exceed the amount which the participant is (or would be) entitled to receive at such time. For example, assume that a profit-sharing plan provides that a participant may withdraw some, but not all, of the participant's account balance before separation from service. A qualified domestic relations order may provide for payment to an alternate payee up to the amount which the participant may withdraw.

A plan may provide for payment to an alternate payee prior to the earliest retirement age as defined under the Act.

D. Cashout of Certain Accrued Benefits (Sec. 1897(d) of the Act, secs. 411(a)(11) and 417 of the Code)

Prior Law

Under prior and present law, in the case of an employee who separates from service, a pension, profit sharing, or stock bonus plan may not immediately distribute the participant's benefit without the participant's consent, if the present value of the participant's accrued benefit exceeds $3,500 (sec. 411(a)(11) of the Code). Under prior law, the interest rate used in determining whether the present value of a benefit exceeds $3,500 could not exceed the interest rate that would be used (as of the date of the distribution) by the Pension Benefit Guaranty Corporation (PBGC) for purposes of determining the present value of a lump sum distribution upon termination of the plan. The PBGC rate in effect at the beginning of a plan year could be used throughout the plan year if the plan so provided.

Under prior and present law, with respect to those plans subject to the automatic survivor benefit requirements, if the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, then the consent of the participant and spouse (or the surviving spouse if the participant has died) is to be obtained before the plan can immediately distribute any part of the present value in a form other than a qualified joint and survivor annuity or a qualified preretirement annuity. Under prior law, the interest rate used could not exceed the interest rate that would be used (as of the date of the distribution) by the PBGC for purposes of determining the present value of a lump sum distribution on plan termination.

For purposes of both the "cash-out" provisions of section 411(a)(11) and the survivor benefit requirements (sec. 417), an accrued benefit is immediately distributable if any part of the benefit may be distributed to the participant before the later of normal retirement age or age 62.

Explanation of Provision

The Act clarifies that, for purposes determining whether a participant's benefit exceeds $3,500, the nonvested portion of the participant's accrued benefit is to be disregarded.

The Act also permits the distribution from an employee stock ownership plan (ESOP) of dividends that are deductible by the employer under section 404(k), without the consent of the participant (or the participant and the participant's spouse) even if the present value of the participant's benefit exceeds $3,500.

E. Notice of Rollover Treatment (Sec. 1897(e) of the Act and secs. 402 and 6652 of the Code)

Prior Law

Under prior and present law, when the administrator of a qualified plan makes a qualifying rollover distribution, the administrator is to provide notice to the recipient that (1) the distribution will not be taxed currently to the extent transferred to another qualified plan or an IRA, and (2) the transfer is to be made within 60 days of receipt in order to qualify for this tax-free rollover treatment.

Failure of the plan administrator to give the required notice of rollover treatment results in imposition of a $10 penalty for each failure (up to $5,000) for each calendar year. This penalty does not apply if the failure is shown to be due to reasonable cause and not to willful neglect.

Explanation of Provision

The Act makes it clear that a plan administrator is to provide notice when making any distribution eligible for rollover treatment. Thus, for example, notice is to be provided when a distribution eligible for rollover treatment pursuant to the partial rollover rules is made.

F. Reduction of Accrued Benefits (Sec. 1897(f) of the Act and sec. 411(d)(6) of the Code)

Prior Law

Under prior and present law, a qualified plan generally may not be amended in a manner that decreases the benefits of a participant accrued prior to the amendment. An amendment is treated as reducing accrued benefits if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

Explanation of Provision

The Act provides that an ESOP will not be treated as violating the rule preventing reductions in accrued benefits merely because the plan sponsor eliminates or retains the discretion to eliminate a lump sum option or an installment payout option with respect to a nondiscriminatory class of employees. Similarly, an employer could retain discretion to limit the option of the plan participants to elect a stock distribution in cases in which the employer becomes substantially employee-owned, or the plan ceases to be an ESOP or a stock bonus plan. In addition, an employer is permitted to eliminate a required cash distribution option in cases in which the employer securities become readily tradable or to require a cash distribution in cases in which stock in the plan is sold in connection with a sale of substantially all of the company. Of course, the plan sponsor is not permitted to eliminate a plan feature that would cause the plan to fail to satisfy the requirements applicable to ESOPs (such as the put option requirement).

An ESOP sponsor is permitted the flexibility to amend the plan to change distribution and payment options under the plan provided any such amendments are within the permissible parameters of the distribution and payment requirements governing ESOPs.

G. Transitional Rules (Sec. 1897(h) of the Act and sec. 303 of the Act)

Prior Law

The qualified joint and survivor annuity and qualified preretirement survivor annuity provisions added by REA generally were effective for plan years beginning after December 31, 1984.

The new rules for qualified joint and survivor benefits and preretirement survivor benefits applied to any participant who performed at least 1 hour of service or had at least 1 hour of paid leave under the plan on or after the date of enactment of REA. In addition, a qualified preretirement survivor annuity must be provided (unless another form of benefit is elected) in the case of any participant who (1) performed at least 1 hour of service or had at least 1 hour of paid leave under the plan on or after August 23, 1984, (2) died before the annuity starting date, and (3) died before the first day of the first plan year to which the provisions applied.

REA immediately imposed certain survivor benefit requirements with respect to participants who died before the plan was required to be amended to comply with the Act. During this transition period, it appeared that a plan was required to make payments to a surviving spouse notwithstanding the possible contractual claims of other designated beneficiaries. However, although the Act was not intended to impose liabilities on pension plans in excess of a participant's accrued benefits or in excess of the survivor benefits required to be provided to surviving spouses, it was unclear whether the survivor benefits required by the Act reduced the total death benefits payable to other designated beneficiaries.

Explanation of Provision

The Act clarifies the application of the transitional rule of REA relating to qualified preretirement survivor benefits in situations in which the participant had designated a beneficiary other than the participant's spouse. Under the Act, the present value of a death benefit payable to any beneficiary with respect to an individual who (1) performs at least 1 hour of service under the plan on or after August 23, 1984, (2) dies before the annuity starting date, and (3) dies before the effective date of REA, may be reduced by the present value of the amount payable to the participant's surviving spouse pursuant to the transition rule. If death benefits payable under a plan are divided among more than one beneficiary, the present value of the amount payable to each beneficiary (including benefits, other than survivor benefits payable under the transition rules, payable to the surviving spouse) is reduced proportionately by the amount payable to the surviving spouse pursuant to the transition rule.

However, the Act also permits the surviving spouse to waive the right to receive the qualified preretirement survivor annuity. Under the Act, if it is made on or before the close of the second plan year to which REA applies, then the waiver is not to be treated as a taxable transfer for purposes of the gift tax or as a prohibited assignment or alienation for purposes of ERISA or the Code. In addition, death benefits waived by the surviving spouse during this period would not be includible in the spouse's income. Such benefits would be includible in the gross income of the recipient.

Finally, the Act clarifies that in the case of a plan that was amended, as of the effective date of REA, to be exempt from the REA survivor benefit requirements, but that (1) was not technically exempt from the survivor benefit requirements during the transition rule period and that (2) failed to satisfy the REA transition rules solely because with respect to a participant who died during the transition period, the plan paid to the surviving spouse the participant's entire vested account balance in a form other than a life annuity, the plan will not be treated as failing to satisfy the survivor benefit requirements of REA.

H. Effective Date for Collectively Bargained Plans (Sec. 1897(c)) of the Act and sec. 303(b) of the Retirement Equity Act)

Prior Law

The provisions of the Retirement Equity Act of 1984 were generally effective for plan years beginning after December 31, 1984. In the case of a plan maintained pursuant to 1 or more collective bargaining agreements ratified by the date of enactment between employee representatives and 1 or more employers, the provisions were generally effective for plan years beginning after the earlier of (1) the date upon which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension agreed to after the date of enactment), or (2) January 1, 1987.

The spousal consent provision of REA was effective for elections (or revocations of elections) made on or after January 1, 1985, with no special effective date for collectively bargained plans. Similarly, the provisions of REA relating to assignments in divorce and separation proceedings generally applied on January 1, 1985, with no special effective date for collectively bargained plans. The provision of REA relating to cutbacks of a participant's accrued benefit was effective July 30, 1984, with a special effective date of April 1, 1985, for plans maintained pursuant to collective bargaining agreements that are successor agreements to one or more collective bargaining agreements that terminated after July 30, 1984, and before January 1, 1985.

Explanation of Provision

The Act would amend REA to provide that, in the case of a plan maintained pursuant to one or more collective bargaining agreements, the provisions of REA are generally effective for plan years beginning after the earlier of (1) the date upon which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension agreed to after the date of enactment), or (2) July 1, 1988.

The amendment does not alter the effective date of the spousal consent provision of REA, the provisions of REA relating to qualified domestic relations orders, or the provision of REA relating to the cutback of a participant's accrued benefit.

I. Loans to Owner-Employees (Sec. 1898(i) of the Act and sec. 408(d) of ERISA)

Prior Law

Under prior law, under ERISA, a plan could not make a loan to an individual who was an owner-employee.

Explanation of Provision

The Act permits a plan to make a loan to an owner-employee if the Secretary of Labor grants an administrative exemption from the prohibited transaction rules with respect to the transaction.

APPENDIX:

REVENUE EFFECT OF TECHNICAL CORRECTION TITLE

The amendments made by the Technical Corrections title (XVIII) of the Tax Reform Act of 1986 are estimated to reduce fiscal year budget receipts by $503 million in 1987, $173 million in 1988, $22 million in 1989, $25 million in 1990, and $39 million in 1991.

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