105TH CONGRESS
1st Session

SENATE

REPORT
105–33

REVENUE RECONCILIATION ACT OF 1997

(AS REPORTED BY THE COMMITTEE ON FINANCE)

S. 949

COMMITTEE ON FINANCE
UNITED STATES SENATE

[Including cost estimate of the Congressional Budget Office]

JUNE 20, 1997.—Ordered to be printed

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U.S. GOVERNMENT PRINTING OFFICE
41–552 WASHINGTON : 1997

CONTENTS

Page

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Mr. ROTH, from the Committee on Finance,
submitted the following

REPORT

[To accompany S. 949]

[Including cost estimate of the Congressional Budget Office]

The Committee on Finance, to which was referred the bill (S. 949) to provide for revenue reconciliation pursuant to section 104(b) of the concurrent resolution on the budget for fiscal year 1998, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

41–552

I. LEGISLATIVE BACKGROUND

Overview

The Senate Committee on Finance (the "Committee") marked up revenue reconciliation provisions on June 19, 1997, and approved the provisions by a roll call vote of 18 yeas and 2 noes. The Committee's revenue reconciliation recommendations are in response to the instructions in the Fiscal Year 1998 Budget Resolution (H. Con. Res. 84) to provide net tax reductions of not more than $85 billion for fiscal years 1998–2002, and not more than $250 billion for fiscal years 1998–2007. (For details on estimated budget effects of the revenue reconciliation provisions as approved by the Committee, see Part III, below.)

Committee hearings

The Committee and subcommittees held public hearings during the 105th Congress on various topics related to the provisions included in the Committee's revenue reconciliation recommendations.

Full committee hearings

The Committee held hearings on the following topics:

Status of the Airport and Airway Trust Fund (February 4, 1997)

Administration's Fiscal Year 1998 Budget Proposal (February 12–13, 1997)

IRA Proposals (March 6, 1997)

Capital Gains and Losses (March 13, 1997)

Estate and Gift Taxes (April 10, 1997)

"Tax Freedom Day" (April 14, 1997)

Education Tax Proposals (April 16, 1997)

Revenue Proposals in the Administration's Fiscal Year 1998 Budget (April 17, 1997)

Amtrak Financing (April 23, 1997)

Children's Access to Health Care (April 30, 1997).

Subcommittee hearings

Subcommittee hearings were held on the following topics:

Administration's Fiscal Year 1998 Health-Related Budget Proposals (Subcommittee on Health, February 12, 1997)

Small Business Tax Proposals (Subcommittee on Taxation and Oversight of the IRS, June 5, 1997).

II. EXPLANATION OF THE BILL

TITLE I. CHILD TAX CREDIT AND OTHER FAMILY TAX RELIEF

A. Child Tax Credit For Children Under Age 17 (sec. 101 of the bill and new sec. 24 of the Code)

Present Law

In general

Present law does not provide tax credits based solely on the taxpayer's number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income ("AGI") in arriving at taxable income. The amount of each personal exemption is $2,650 for 1997, and is adjusted annually for inflation. In 1997, the amount of the personal exemption is phased out for taxpayers with AGI in excess of $121,200 for single taxpayers, $151,500 for heads of household, and $181,800 for married couples filing joint returns. These phaseout threshold are adjusted annually for inflation.

Reasons for Change

The Committee believes that the individual income tax structure does not reduce tax liability by enough to reflect a family's reduced ability to pay taxes as family size increases. In part, this is because over the last 50 years the value of the dependent personal exemption has declined in real terms by over one-third. The Committee believes that a tax credit for families with dependent children will reduce the individual income tax burden of those families, will better recognize the financial responsibilities of raising dependent children, and will promote family values. In addition, the Committee believes that the credit is an appropriate vehicle to encourage taxpayers to save for their children's education.

Explanation of Provision

The bill allows taxpayers a maximum nonrefundable tax credit of $500 (pro rate amount of $250 in 1997 for children under the age of 13) for each qualifying child under the age of 17. For taxable years beginning after December 31, 2002, the credit is allowed for each qualifying child under the age of 18. A qualifying child is defined as an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer. The credit amount is not indexed for inflation.

In the case of each child age 13 to 16 (13 to 17 for taxable years beginning after December 31, 2002), the credit is available only for amounts contributed to savings for education with respect to that child. Specifically, the credit is allowed only to the extent of the net amount deposited into a qualified tuition program or an education IRA (as described below) on or before April 15 of the year following the year with respect to which the credit is claimed. Generally, if amounts are withdrawn, other than for qualified educational expenses, on or before April 15 of the second year following the year with respect to which the credit is claimed, the credit is subject to a 100-percent recapture. Exceptions from the 100-percent recapture are provided in certain circumstances including withdrawals made due to death, disability, and receipt of certain scholarships by the beneficiary.

For taxpayers with AGI in excess of certain threshold, the otherwise allowable child credit is phased out. Specifically, the otherwise allowable child credit is reduced by $25 for each $1,000 of modified AGI (or fraction thereof) in excess of the threshold ("the modified AGI phase-out"). For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Marina Islands; and residents of Puerto Rico, respectively). For married taxpayers filing joint returns, the threshold is $110,000. For taxpayers filing single or head of household returns, the threshold is $75,000. For married taxpayers filing separate returns, the threshold is $55,000. These threshold are not indexed for inflation.

The maximum amount of the child credit for each taxable year can not exceed an amount equal to the excess of: (1) the taxpayer's regular income tax liability (net of applicable credits) over (2) the sum of the taxpayer's tentative minimum tax liability (determined without regard to the alternative minimum foreign tax credit) and one-half of the earned income credit allowed.

Effective Date

The child tax credit is effective July 1, 1997, for taxable years beginning after December 31, 1996.

B. Increase Exemption Amounts Applicable to Individual Alternative Minimum Tax (sec. 102 of the bill and sec. 55 of the Code)

Present Law

Present law imposes a minimum tax on an individual to the extent the taxpayer's minimum tax liability exceeds his or her regular tax liability. This alternative minimum tax is imposed upon individuals at rates of (1) 26 percent on the first $175,000 of alternative minimum taxable income in excess of a phased-out exemption amount and (2) 28 percent on the amount in excess of

$175,000. The exemptions amounts are $45,000 in the case of married individuals filing a joint return and surviving spouses; $33,750 in the case of other unmarried individuals; and $22,500 in the case of married individuals filing a separate return. These exemption amounts are phased-out by an amount equal to 25 percent of the amount that the individual's alternative minimum taxable income exceeds a threshold amount. These threshold amounts are $150,000 in the case of married individuals filing a joint return and surviving spouses; $112,500 in the case of other unmarried individuals; and $75,000 in the case of married individuals filing a separate return, estates, and trusts. The exemption amounts, the threshold phase-out amounts, and the $175,000 break-point amount are not indexed for inflation.

Reasons for Change

The Committee is concerned about the projected trend that significantly more individuals without tax preferences or adjustments will become subject to the alternative minimum tax in the near future. This trend is projected, in part, because the exemption amounts applicable to the individual alternative minimum tax are not increased for inflation, while the standard deduction, personal exemptions, rate brackets and other features of the regular tax are so increased.

Explanation of Provision

For taxable years beginning after 2000 and before 2003, the exemption amounts of the individual alternative minimum tax are increased as follows in each year: (1) by $600 in the case of married individuals filing a joint return and surviving spouses; (2) by $450 in the case of other unmarried individuals; and (3) by $300 in the case of married individuals filing separate returns. For taxable years beginning after 2003, the exemption amounts of the individual alternative minimum tax are increased as follows in each year: (1) by $950 in the case of married individuals filing a joint return and surviving spouses; (2) by $700 in the case of other unmarried individuals; and (3) by $475 in the case of married individuals filing separate returns.

Effective Date

The provision is effective for taxable years beginning after December 31, 2000.

TITLE II. EDUCATION TAX INCENTIVES

A. Tax Benefits Relating to Education Expenses

1. HOPE credit for higher education tuition expenses (sec. 201 of the bill and new sec. 25A of the Code)

Present Law

Deductibility of education expenses

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162–5). However, education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above- described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

Exclusion for employer-provided educational assistance

A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to $5,250 annually paid by his or her employer for educational assistance (sec. 127). In order for the exclusion to apply certain requirements must be satisfied, including a requirement that not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners. This special rule for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997 (and does not apply to graduate level courses beginning after June 30, 1996).

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education expenses would be deductible under section 162.

Exclusion for interest earned on savings bonds

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[1] "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between $49,450 and $64,450 ($74,200 and $104,200 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Qualified scholarships

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. There is, however, no dollar limitation for the section 117 exclusion, provided that the scholarship funds are used to pay for tuition and required fees. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations. Section 117(c) specifically provides that the exclusion for qualified scholarships does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship.

Student loan forgiveness

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (e.g., providing health care services to a

[1] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

nonprofit organization). Student loans eligible for this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

Qualified State prepaid tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.[2]

[2] Specifically, section 529(c)(3)(A) provides that any distribution under a qualified State tuition program shall be includible in the gross income of the distributee in the same manner as provided under present-law section 72 to the extent not excluded from gross income under any other provision of the Code.

Reasons for Change

To assist low- and middle-income families and students in paying for the costs of post-secondary education, the Committee believes that taxpayers should be allowed to claim a credit (referred to as a "HOPE" credit) against Federal income taxes for certain tuition and related expenses incurred during a student's first two years of attendance (on at least a half-time basis) at a college, university, or certain vocational schools.

Explanation of Provision

In general

Under the bill, individual taxpayers are allowed to claim a nonrefundable HOPE credit against Federal income taxes up to $1,500 per student per year for 50 percent of qualified tuition and related expenses (but not room and board expenses) paid for the first two years of the student's post-secondary education in a degree or certificate program. In the case of a student attending a community college (i.e., a so-called "two-year" or "junior" college) or vocational school, the maximum HOPE credit equals 75 percent (rather than 50 percent) of qualified tuition and related expenses, subject to a maximum credit of $1,500 per student per year.[3] The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent. The HOPE credit will be available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education. Beginning in 1999, the maximum HOPE credit amount of $1,500 will be indexed for inflation, rounded down to the closest multiple of $50.[4]

The HOPE credit amount that a taxpayer may otherwise claim will be phased out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). Modified AGI includes amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2001, the income phase-out ranges will be indexed for inflation, rounded down to the closest multiple of $5,000.

The HOPE credit will be available for the taxable year in which the expenses are paid, subject to the requirement that the education commence or continue during that year or during the first three months of the next year. Qualified tuition expenses paid with

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[3] Thus, students attending community colleges or vocational schools may be eligible for the $1,500 maximum HOPE credit if they incur $2,000 of qualified tuition and related expenses. In contrast, students attending other institutions (e.g., four-year colleges) may be eligible for the $1,500 maximum HOPE credit if they incur $3,000 of qualified tuition and related expenses.

For purposes of the 75-percent credit rate, "community colleges" are defined as any institution of higher education (as defined in sec. 1201 of the Higher Education Act of 1965 (20 U.S.C. 1141)) that awards an associate's degree. "Vocational schools" are defined as post-secondary vocational institutions (as defined in sec. 481 of the Higher Education Act of 1965 (20 U.S.C. 1088)).

[4] The HOPE credit may not be claimed against a taxpayer's alternative minimum tax (AMT) liability.

the proceeds of a loan generally will be eligible for the HOPE credit (rather than repayment of the loan itself).[5]

Dependent students

A taxpayer may claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse (e.g., in cases where the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the eligible student him- or herself is *not* entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

Election of HOPE credit or proposed exclusion for distributions from a qualified tuition program or education IRA

For a taxable year, a taxpayer may elect with respect to an eligible student *either* the HOPE credit (assuming that all the requirements of the HOPE credit are satisfied) *or* the exclusion for distributions from a qualified tuition program or education IRA used to cover qualified higher education expenses (described below).[6] If a child is *not* claimed as a dependent by the parent (or by any other taxpayer) for the taxable year, then the child him- or herself will have the option of electing either the HOPE credit or proposed exclusion for distributions from a qualified tuition program or education IRA used to cover qualified higher education expenses.

Qualified tuition and related expenses

The HOPE credit is available for "qualified tuition and related expenses," meaning tuition, fees, and books required for the enrollment or attendance of an eligible student at an eligible educational institution. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal, living or family expenses are not eligible for the HOPE credit. The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition expenses do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total tuition and related expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free

[5] The Treasury Department will have authority to issue regulations providing that the HOPE credit will be recaptured in cases where the student or taxpayer receives a refund of tuition and related expenses with respect to which a credit was claimed in a prior year.

[6] For any taxable year, a taxpayer may claim the HOPE credit for qualified tuition and related expenses paid with respect to one student and also claim the proposed exclusion for distributions made from a qualified tuition program or education IRA (described below) used to cover higher education expenses paid with respect to one or more *other* students. If the HOPE credit is claimed with respect to one student for one or two taxable years, then the exclusion for distributions from a qualified tuition program or education IRA may be available with respect to that same student for subsequent taxable years.

educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127. No reduction of qualified tuition expenses is required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). Under the bill, a HOPE credit will not be allowed with respect to any education expenses for which a deduction is claimed under section 162 or any other section of the Code.[7]

Eligible student

An eligible student is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. (In other words, for at least one academic period which begins during the taxable year, the student must carry at least one-half the normal full-time work load for the course of study the student is pursuing.) An eligible student is required to have earned a high-school diploma (or equivalent degree) prior to attending any post-secondary classes with respect to which a HOPE credit is claimed, with the exception of students who did not receive a high-school degree by reason of enrollment in an early admission program to an eligible educational institution. An eligible student may not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institution

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

Regulations

The Secretary of the Treasury (in consultation with the Secretary of Education) will have authority to issue regulations to implement the provision, including regulations providing appropriate rules for recordkeeping and information reporting. These regulations will address the information reports that eligible educational institutions will be required to file to assist students and the IRS in calculating the amount of the HOPE credit potentially available.

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[7] In addition, the bill amends present-law section 135 to provide that the amount of qualified higher education expenses taken into account for purposes of that section is reduced by the amount of such expenses taken into account in determining the HOPE credit allowed to any taxpayer with respect to the student for the taxable year.

Effective Date

The provision applies to expenses paid after December 31, 1997, for education furnished in academic periods beginning after such date.

2. Exclusion from gross income for amounts distributed from qualified tuition programs and education IRAs to cover qualified higher education expenses (secs. 211, 212, and 213 of the bill and sec. 529 and new sec. 530 of the Code)

Present Law

Deductibility of education expenses

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162–5). However, education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above-described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income (AGI).

Exclusion for employer-provided educational assistance

A special rule allows an employee to exclude from gross income for income tax purposes and from wages for employment tax purposes up to $5,250 annually paid by his or her employer for educational assistance (sec. 127). In order for the exclusion to apply certain requirements must be satisfied, including a requirement that not more than 5 percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance program can be provided for the class of individuals consisting of more than 5-percent owners of the employer and the spouses or dependents of such more than 5-percent owners. This special rule for employer-provided educational assistance expires with respect to courses beginning after June 30, 1997 (and does not apply to graduate level courses beginning after June 30, 1996).

For purposes of the special exclusion, educational assistance means the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment. Educational assistance also includes the provision by the employer of courses of instruction for the employee (including books, supplies, and equipment). Educational assistance does not include tools or supplies which may be retained by the employee after completion of a course or meals, lodging, or transportation. The exclusion does not apply to any education involving sports, games, or hobbies.

In the absence of the special exclusion, employer-provided educational assistance is excludable from gross income and wages as a working condition fringe benefit (sec. 132(d)) only to the extent the education expenses would be deductible under section 162.

Exclusion for interest earned on savings bonds

Another special rule (sec. 135) provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[8] "Qualified higher education expenses" include tuition and fees (but not room and board expenses) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools. The exclusion provided by section 135 is phased out for certain higher-income taxpayers, determined by the taxpayer's modified AGI during the year the bond is redeemed. For 1996, the exclusion was phased out for taxpayers with modified AGI between $49,450 and $64,450 ($74,200 and $104,200 for joint returns). To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

Qualified scholarships

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. There is, however, no dollar limitation for the section 117 exclusion, provided that the scholarship funds are used to pay for tuition and required fees. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations. Section 117(c) specifically provides that the exclusion for qualified scholarships does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship.

[8] If the aggregate redemption amount (i.e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

Student loan forgiveness

In the case of an individual, section 108(f) provides that gross income subject to Federal income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers (e.g., providing health care services to a nonprofit organization). Student loans eligible for this special rule must be made to an individual to assist the individual in attending an education institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses (in contrast to tax-free scholarships under section 117, which are limited to tuition and required fees). In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the section 108(f) exclusion. As with section 117, there is no dollar limitation for the section 108(f) exclusion.

Qualified State prepaid tuition programs

Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Qualified higher education expenses do not include room and board expenses. Section 529 also provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.[9]

Contributions made to a qualified State tuition program are treated as incomplete gifts for Federal gift tax purposes (sec. 529(c)(2)). Thus, any Federal gift tax consequences are determined at the time that a distribution is made from an account under the program. The waiver (or payment) of qualified higher education expenses of a designated beneficiary by (or to) an educational institution under a qualified State tuition program is treated as a qualified transfer for purposes of present-law section 2503(e). Amounts contributed to a qualified State tuition program (and earnings thereon) are includible in the contributor's estate for Federal estate tax purposes in the event that the contributor dies before such amounts are distributed under the program (sec. 529(c)(4)).

Individual retirement arrangements ("IRAs")

An individual may make deductible contributions to an individual retirement arrangement ("IRA") for each taxable year up to the lesser of $2,000 or the amount of the individual's compensation for the year if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). Contributions may be made to an IRA for a taxable year up to April 15th of the following year. An individual who makes excess contributions to an IRA, i.e., contributions in excess of $2,000, is subject to an excise tax on such excess contributions unless they are distributed from the IRA before the due date for filing the individual's tax return for the year (including extensions). If the individual (or his or her spouse, if married) is an active participant, the $2,000 limit is phased out between $40,000 and $50,000 of adjusted gross income ("AGI") for married couples and between $25,000 and $35,000 of AGI for single individuals.

Present law permits individuals to make nondeductible contributions (up to $2,000 per year) to an IRA to the extent an individual is not permitted to (or does not) make deductible contributions. Earnings on such contributions are includible in gross income when withdrawn.

An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA. Amounts withdrawn from an IRA are includible in gross income (except to the extent of nondeductible contributions). In addition, a 10-percent additional tax generally applies to distributions from IRAs made before age 59½, unless the distribution is made (1) on account of death or disability, (2) in the form of annuity payments, (3) for medical expenses of the individual and his or her spouse and dependents that exceed 7.5 percent of AGI, or (4) for medical insurance of the individual and his or her spouse and dependents (without regard to the 7.5 percent of AGI floor) if the individual has received unemployment compensation for at least 12 weeks, and the withdrawal is made

[9] Specifically, section 529(c)(3)(A) provides that any distribution under a qualified State tuition program shall be includible in the gross income of the distributee in the same manner as provided under present-law section 72 to the extent not excluded from gross income under any other provision of the Code.

in the year such unemployment compensation is received or the following year.

Reasons for Change

To encourage families and students to save for future education expenses, the Committee believes that tax-exempt status should be granted to certain prepaid tuition programs operated by States or private educational institutions and to certain education investment accounts (referred to as "education IRAs") established by taxpayers on behalf of future students. The Committee further believes that distributions from such programs and accounts should not be subject to Federal income tax to the extent that the amounts distributed are used to pay for qualified higher education expenses of an undergraduate or graduate student who is attending a college, university, or certain vocational schools on at least a half-time basis.

Explanation of Provision

In general

Under the bill, amounts distributed from qualified tuition programs and certain education investment accounts (referred to as "education IRAs") are excludable from gross income to the extent that the amounts distributed do not exceed qualified higher education expenses of an eligible student incurred during the year the distribution is made.[10] An exclusion is *not* allowed under the bill with respect to an otherwise eligible student if the HOPE credit (as described previously) is claimed with respect to that student for the taxable year the distribution is made.[11]

Under the bill, distributions from a qualified tuition program or education IRA generally will be deemed to consist of distributions of principal (which, under all circumstances, are excludable from gross income) and earnings (which *may be* excludable from gross income under the bill) by applying the ratio that the aggregate amount of contributions to the program or account for the beneficiary bears to the total balance (or value) of the program or account for the beneficiary at the time the distribution is made.[12] If the qualified higher education expenses of the student for the year are at least equal to the total amount of the distribution (i.e., principal and earnings combined) from a qualified tuition program or education IRA, then the earnings in their entirety will be exclud-

[10] The exclusion will not be a preference item for alternative minimum tax (AMT) purposes.

[11] If a HOPE credit was claimed with respect to a student for an earlier taxable year (i.e., the student's first or second year of post-secondary education), the exclusion provided for by the bill may be claimed with respect to that student for a *subsequent* taxable year.

[12] Specifically, the bill provides as a general rule that distributions from a qualified tuition program or education IRA are includible in gross income to the extent allocable to income on the program or account and are *not* includible in gross income to the extent allocable to the investment (i.e., contributions) in the program or account. However, the bill further provides that, if the HOPE credit is not claimed with respect to the student for the taxable year, then a distribution from a qualified tuition program or education IRA will *not* be includible in gross income *to the extent* that the distribution does not exceed the qualified higher expenses of the student for the year. If a distribution consists of providing in-kind education benefits to the student which, if paid for by the student, would constitute payment of qualified higher education expenses, then no portion of such distribution will be includible in gross income.

At the time that a final distribution is made for a qualified tuition program or education IRA, the distribution will be deemed to include the full amount of any basis remaining with respect to the program or account.

able from gross income. If, on the other hand, the qualified higher education expenses of the student for the year are *less than* the total amount of the distribution (i.e., principal and earnings combined) from a qualified tuition program or education IRA, then the qualified higher education expenses will be deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings will be excludable under the bill (i.e., a portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the remaining portion of the earnings will be includible in the gross income of the distributee.[13]

Eligible students

To be an eligible student under the bill, an individual must be at least a half-time student in a degree or certificate undergraduate or graduate program at an eligible educational institution. For this purpose, a student is at least a half-time student if he or she is carrying at least one-half the normal full-time work load for the course of study the student is pursuing. An eligible student may not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institution

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

Qualified higher education expenses

Under the bill, the definition of "qualified higher education expenses" include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible education institution, as well as room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for Federal financial aid programs under sec. 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses.

Qualified higher education expenses generally include only out-of-pocket expenses. Qualified higher education expenses do not in-

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[13] For example, if a $1,000 distribution from a qualified tuition program or education IRA consists of $600 of principal (i.e., contributions) and $400 of earnings, and if the student incurs $750 of qualified higher education expenses during the year, then $300 of the earnings will be excludable from gross income under the bill (i.e., an exclusion will be provided for the pro-rata portion of the earnings, based on the ratio that the $750 of qualified expenses bears to the $1,000 total distribution) and the remaining $100 of earnings will be includible in the distributee's gross income.

clude expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127. In addition, qualified higher education expenses do not include expenses paid with amounts that are excludible under section 135. No reduction of qualified higher education expenses is required for a gift, bequest, devise, or inheritance within the meaning of section 102(a). If education expenses for a taxable year are deducted under section 162 or any other section of the Code, then such expenses are not qualified higher education expenses under the bill.

Qualified tuition programs and education IRAs

Under the bill, a "qualified tuition program" means any qualified State-sponsored tuition program, defined under section 529 (as modified by the bill), as well as any program established and maintained by one or more eligible educational institutions (which could be private institutions) that satisfy the requirements under section 529 (other than present-law State ownership rule). An "education IRA" means a trust (or custodial account) which is created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the account holder and which satisfies certain other requirements.

Contributions to qualified tuition programs or education IRAs may be made only in cash.[14] Such contributions may not be made after the designated beneficiary or account holder reaches age 18. Annual contributions to a qualified tuition program not maintained by a State (i.e., a qualified tuition program operated by one or more private schools) or to an education IRA are limited to $2,000 per beneficiary or account holder, *plus* the amount of any child credit (as provided for by the bill and described above) that is allowed for the taxable year with respect to the beneficiary or account holder.[15] Thus, in the case of any child with respect to whom the maximum $500 child credit is allowed for the taxable year, the contribution limit with respect to such child for the year will be $2,500.[16] Trust-

[14] The bill allows taxpayers to redeem U.S. Savings Bonds and be eligible for the exclusion under section 135 (as if the proceeds were used to pay qualified higher education expenses) if the proceeds from the redemption are contributed to a qualified tuition program or education IRA on behalf of the taxpayer, the taxpayer's spouse, or a dependent. In such a case, the beneficiary's or account holder's basis in the bond proceeds contributed on his or her behalf to the qualified tuition program or education IRA will be the contributor's basis in the bonds (i.e., the original purchase price paid by the contributor for such bonds).

The bill also provides that funds from an education IRA are deemed to be distributed to pay qualified higher education expenses if the funds are used to make contributions to (or purchase tuition credits from) a qualified tuition program for the benefit of the account holder.

[15] State-sponsored qualified tuition programs will continue to be governed by the rule contained in present-law section 529(b)(7) that such programs provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. State-sponsored qualified tuition programs will *not* be subject to a specific dollar limit on annual contributions that can be made under the program on behalf of a designated beneficiary.

[16] The maximum contribution limit for the year is increased even if the child is younger than age 13—that is, even in cases where the parent is not *required* (under the provision described previously) but may elect to deposit an amount equal to the child credit into a qualified tuition program or education IRA on behalf of the child.

ees of qualified tuition programs not maintained by a State and trustees of education IRAs are prohibited from accepting contributions to any account on behalf of a beneficiary in excess of $2,500 for any year (except in cases involving certain tax-free rollovers, as described below).[17]

If any balance remaining in an education IRA is not distributed by the time that the account holder becomes 30 years old, then the account will be deemed to be an IRA Plus account (as provided for by the bill and described below) established on behalf of the same account holder.[18] The bill allows (but does not require) tax-free transfers or rollovers of account balances from a qualified tuition program to an IRA Plus account when the beneficiary becomes 30 years old, provided that the funds from the qualified tuition program account are deposited in the IRA Plus account within 60 days after being distributed from the qualified tuition program.[19] In addition, the bill allows tax-free transfers or rollovers of credits or account balances from one qualified tuition program or education IRA account benefiting one beneficiary to another program or account benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary.[20]

Qualified tuition programs and education IRAs (as separate legal entities) will be exempt from Federal income tax, other than taxes imposed under the present-law unrelated business income tax (UBIT) rules.[21]

Under the bill, an additional 10-percent penalty tax will be imposed on any distribution from a qualified tuition program not maintained by a State or from an education IRA to the extent that the distribution exceeds qualified higher education expenses incurred by the taxpayer (and is not made on account of the death, disability, or scholarship received by the designated beneficiary or account holder).[22]

Estate and gift tax treatment

Contributions to qualified tuition programs and education IRAs will not be considered taxable gifts for Federal gift tax purposes, and in no event will distributions from qualified tuition programs

[17] The annual $2,000 to $2,500 contribution limit is applied by taking into account all contributions made to any qualified tuition program not maintained by a State *and* any education IRA on behalf of a designated individual (but not any contributions made to State-sponsored qualified tuition programs). To the extent contributions exceed the annual contribution limit, an excise tax penalty may be imposed on the contributor under present-law section 4973, unless the excess contributions (and any earnings thereon) are returned to the contributor before the due date for the return for the taxable year during which the excess contribution is made.

[18] In such cases, the 5-year holding period applicable to IRA Plus accounts begins with the taxable year in which the education IRA is deemed to be an IRA Plus account.

[19] In the event of such a rollover, the 5-year holding period applicable to IRA Plus accounts begins with the taxable year in which the rollover occurs.

[20] For this purpose, a "member of the family" means persons described in paragraphs (1) through (8) of section 152(a), and any spouse of such persons.

[21] An interest in a qualified tuition program is not treated as debt for purposes of the debt-financed property UBIT rules of section 514.

[22] Distributions from State-sponsored qualified tuition programs will *not* be subject to this 10-percent additional penalty tax, but will continue to be governed by the present-law section 529(b)(3) rule that the State-sponsored programs themselves are required to impose a "more than de minimis penalty" on any refund of earnings not used for qualified higher education expenses (other than in cases where the refund is made on account of death or disability of, or receipt of a scholarship by, the beneficiary).

or education IRAs be treated as a taxable gifts.[23] For estate tax purposes, the value of any interest in a qualified tuition program or education IRA will be includible in the estate of the designated beneficiary. In no event will such an interest be includible in the estate of the contributor.

Effective Date

The provision applies to distributions made, and qualified higher education expenses paid, after December 31, 1997, for education furnished in academic periods beginning after such date. The provisions governing contributions to, and the tax-exempt status of, qualified tuition plans and education IRAs generally apply after December 31, 1997. The gift tax provisions are effective for contributions (or transfers) made after the date of enactment, and the estate tax provisions are effective for decedents dying after June 8, 1997.

3. Deduction for student loan interest (sec. 202 of the bill and new sec. 221 of the Code)

Present Law

The Tax Reform Act of 1986 repealed the deduction for personal interest. Student loan interest generally is treated as personal interest and thus is not allowable as an itemized deduction from income.

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162–5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's adjusted gross income (AGI).

Reasons for Change

The Committee is aware that many students incur considerable debt in the course of obtaining undergraduate and graduate education. The Committee believes that permitting a deduction for interest on certain student loans will help to ease the financial burden that such obligations represent.

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[23] Contributions to only one State-sponsored qualified tuition program per beneficiary will be excluded from the gift tax by reason of the bill (although a contributor may also make contributions excluded from the gift tax on behalf of *other* beneficiaries to the same State- sponsored program or any other State-sponsored program).

Explanation of Provision

Under the bill, certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum deduction of $2,500 per year. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. Beginning in 1999, the maximum deduction of $2,500 is indexed for inflation, rounded down to the closest multiple of $50.

A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. Qualified higher education expenses are defined as the student's cost of attendance as defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from gross income under section 135 (i.e., United States savings bonds used to pay higher education tuition and fees), (2) any amount distributed from a qualified tuition program or education investment account and excluded from gross income (under the provision described above), and (3) the amount of any scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127. Such expenses must be paid or incurred within a reasonable period before or after the indebtedness is incurred, and must be attributable to a period when the student is at least a half-time student.

The deduction is phased out ratably for taxpayers with modified adjusted gross income (AGI) between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). Modified AGI includes amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions), and is calculated after application of section 86 (income inclusion of certain Social Security benefits), section 219 (deductible IRA contributions), and section 469 (limitation on passive activity losses and credits).[24] Beginning in 2001, the income phase-out ranges are indexed for inflation, rounded down to the closest multiple of $5,000.

Any person in a trade or business or any governmental agency that receives $600 or more in qualified education loan interest from

[24] For purposes of sections 86, 135, 219, and 469, adjusted gross income is determined without regard to the deduction for student loan interest.

an individual during a calendar year must provide an information report on such interest to the IRS and to the payor.

Effective Date

The provision is effective for payments of interest due after December 31, 1996, on any qualified education loan. Thus, in the case of already existing qualified education loans, interest payments qualify for the deduction to the extent that the 60-month period has not expired. For purposes of counting the 60 months, any qualified education loan and all refinancing (that is treated as a qualified education loan) of such loan are treated as a single loan.

4. Penalty-free withdrawals from IRAs for higher education expenses (sec. 203 of the bill and sec. 72(t) of the Code)

Present Law

An individual may make deductible contributions to an individual retirement arrangement ("IRA") for each taxable year up to the lesser of $2,000 or the amount of the individual's compensation for the year if the individual is not an active participant in an employer-sponsored qualified retirement plan (and, if married, the individual's spouse also is not an active participant). In the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out over certain adjusted gross income ("AGI") levels. The limit is phased out between $40,000 and $50,000 of AGI for married taxpayers, and between $25,000 and $35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70½.

Amounts held in an IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

Reasons for Change

The Committee believes that it is both appropriate and important to allow individuals to withdraw amounts from their IRAs for purposes of paying higher education expenses without incurring an additional 10-percent early withdrawal tax.

Explanation of Provision

The bill provides that the 10-percent early withdrawal tax does not apply to distributions from IRAs (including IRA Plus accounts created by the bill) if the taxpayer uses the amounts to pay qualified higher education expenses (including those related to graduate-level courses) of the taxpayer, the taxpayer's spouse, or any child, or grandchild of the taxpayer or the taxpayer's spouse.

The penalty-free withdrawal is available for "qualified higher education expenses," meaning tuition, fees, books, supplies, equipment required for enrollment or attendance, and room and board at a post-secondary educational institution (defined by reference to sec. 481 of the Higher Education Act of 1965). Qualified higher education expenses are reduced by any amount excludable from gross income under section 135 relating to the redemption of a qualified U.S. savings bond and certain scholarships and veterans benefits.

Effective Date

The provision is effective for distributions after December 31, 1997, with respect to expenses paid after such date for education furnished in academic periods beginning after such date.

B. Other Education-Related Tax Provisions

1. Extension of exclusion for employer-provided educational assistance (sec. 221 of the bill and sec. 127 of the Code)

Present Law

Under present law, an employee's gross income and wages do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion is limited to $5,250 of educational assistance with respect to an individual during a calendar year. The exclusion does not apply to graduate level courses beginning after June 30, 1996. The exclusion expires with respect to courses beginning after June 30, 1997.[25] In the absence of the exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

Reasons for Change

The Committee believes that the exclusion for employer-provided educational assistance has enabled millions of workers to advance their education and improve their job skills without incurring additional taxes and a reduction in take-home pay. In addition, the exclusion lessens the complexity of the tax laws. Without the special exclusion, a worker receiving educational assistance from his or her employer is subject to tax on the assistance, unless the education is related to the worker's current job. Because the determination of whether particular educational assistance is job-related is based on the facts and circumstances, it may be difficult to determine with certainty whether the educational assistance is excludable from income. This uncertainty may lead to disputes between taxpayers and the Internal Revenue Service.

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[25] The legislative history reflects congressional intent that the provision expire with respect to courses beginning after May 31, 1997.

The Committee believes that reinstating the exclusion for graduate-level employer-provided educational assistance will enable more individuals to seek higher education, and that a permanent extension of the exclusion is important. The past experience of allowing the exclusion to expire and subsequently retroactively extending it has created burdens for employers and employees. Employees may have difficulty planning for their educational goals if they do not know whether their tax bills will increase. For employers, the fits and starts of the legislative history of the provision have caused severe administrative problems. Uncertainty about the exclusion's future may discourage some employers from providing educational benefits.

Explanation of Provision

The bill permanently extends the exclusion for employer-provided educational assistance. Beginning in 1997, the exclusion applies to graduate-level courses as well as undergraduate courses.

Effective Date

The extension of the exclusion with respect to undergraduate courses applies to taxable years beginning after December 31, 1996. The extension of the exclusion to graduate-level courses applies to courses of instruction beginning after December 31, 1996.

2. Modification of $150 million limit on qualified 501(c)(3) bonds other than hospital bonds (sec. 222 of the bill and sec. 145(b) of the Code)

Present Law

Interest on State and local government bonds generally is excluded from income if the bonds are issued to finance activities carried out and paid for with revenues of these governments. Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in Code section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business.

Present law treats section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(1)(3) bonds," subject to the restrictions of Code section 145. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organizations under common management or control are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations.

Reasons for Change

The Committee believes a distinguishing feature of American society is the singular degree to which the United States maintains a private, non-profit sector of private higher education and other charitable institutions in the public service. The Committee believes it is important to assist these private institutions in their advancement of the public good. The Committee finds particularly inappropriate the restrictions of present law which place these section 501(c)(3) organizations at a financial disadvantage relative to substantially identical governmental institutions. For example, a public university generally has unlimited access to tax-exempt bond financing, while a private, non-profit university is subject to a $150 million limitation on outstanding bonds from which it may benefit. The Committee is concerned that this and other restrictions inhibit the ability of America's private, non-profit institutions to modernize their educational facilities. The Committee believes the tax-exempt bond rules should treat more equally State and local governments and those private organizations which are engaged in similar actions advancing the public good.

Explanation of Provision

The $150 million limit is repealed for bonds issued after the date of enactment to finance capital expenditures incurred after date of the enactment.

Effective Date

The provision is effective for bonds issued after the date of enactment to finance capital expenditures incurred after the date of enactment.

3. Expansion of arbitrage rebate exception for certain bonds (sec. 223 of the bill and sec. 148 of the Code)

Present Law

Generally, all arbitrage profits earned on investments unrelated to the purpose of the borrowing ("nonpurpose investments") when such earnings are permitted must be rebated to the Federal Government.

An exception is provided for bonds issued by governmental units having general taxing powers if the governmental unit (and all subordinate units) issues $5 million or less of governmental bonds during the calendar year ("the small-issuer exception'). This exception does not apply to private activity bonds.

Reasons for Change

The Committee recognizes the need for additional monies to address the needs of our crumbling public school infrastructure. It believes that this provision will reduce the compliance costs of issuers of tax-exempt debt issued for public school construction.

Explanation of Provision

The bill provides that up to $5 million dollars of bonds used to finance public school capital expenditures incurred after December 31, 1997, are excluded from application of the present-law $5 million limit. Thus, small issuers will continue to benefit from the small issue exception from arbitrage rebate if they issue no more than $10 million in governmental bonds per calendar year and no more than $5 million of the bonds is used to finance expenditures other than for public school capital expenditures.

Effective Date

The provision is effective for bonds issued after December 31, 1997.

4. Certain teacher education expenses not subject to 2 percent limit on miscellaneous itemized deductions (sec. 224 of the bill and sec. 67(b) of the Code)

Present Law

In general, taxpayers are not permitted to deduct education expenses. However, employees may deduct the cost of certain work-related education. For costs to be deductible, the education must either be required by the taxpayer's employer or by law to retain taxpayer's current job or be necessary to maintain or improve skills required in the taxpayer's current job. Expenses incurred for education that is necessary to meet minimum education requirements of an employee's present trade or business or that can qualify an employee for a new trade or business are not deductible.

An employee is allowed to deduct work-related education and other business expenses only to the extent such expenses (together with other miscellaneous itemized deductions) exceed 2 percent of the taxpayer's adjusted gross income.

Reasons for Change

The Committee believes that, in addition to making higher education accessible and affordable through various tax incentives, it is important to encourage elementary and secondary school teachers to obtain the necessary academic skills and training to prepare their students successfully to pursue higher education.

Explanation of Provision

Under the bill, qualified professional development expenses incurred by an elementary or secondary school teacher [26] with respect to certain courses of instruction are not subject to the 2 percent floor on miscellaneous itemized deductions. Qualified professional development expenses mean expenses for tuition, fees, books, supplies, equipment and transportation required for enrollment or attendance in a qualified course, *provided* that such expenses are otherwise deductible under present law section 162. A qualified course of instruction means a course at an institution of higher education (as defined in section 481 of the Higher Education Act of 1965) which is part of a program of professional development that is approved and certified by the appropriate local educational agency as furthering the individual's teaching skills.

[26] To be eligible, a teacher must have completed at least two academic years as a K–12 teacher in an elementary or secondary school before the qualified professional development expenses are incurred.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

TITLE III. SAVINGS AND INVESTMENT INCENTIVES

A. Individual Retirement Arrangements (secs. 301–304 of the bill and secs. 72 and 408 of the Code and new sec. 408A of the Code)

Present Law

Under present law, an individual may make deductible contributions to an individual retirement arrangement ("IRA") up to the lesser of $2,000 or the individual's compensation if the individual is not an active participant in an employer-sponsored retirement plan (and, if married, the individual's spouse also is not an active participant in such a plan). If the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a home maker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out over certain adjusted gross income ("AGI") levels. The limit is phased out between $40,000 and $50,000 of AGI for married taxpayers, and between $25,000 and $35,000 of AGI for single taxpayers. An individual may make nondeductible IRA contributions to the extent the individual is not permitted to make deductible IRA contributions. Contributions cannot be made to an IRA after age 70½.

Amounts held in an IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of AGI, or is used to purchase health insurance of an unemployed individual.

In general, distributions from an IRA are required to begin at age 70½. An excise tax is imposed if the minimum required distributions are not made. Distributions to the beneficiary of an IRA are generally required to begin within 5 years of the death of the IRA owner, unless the beneficiary is the surviving spouse.

A 15-percent excise tax is imposed on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs. In general, excess distributions are defined as the aggregate amount of retirement distributions (i.e., payments from applicable retirement plans) made with respect to an individual during any calendar year to the extent such amounts exceed $160,000 (for 1997) or 5 times that amount in the case of a lump-sum distribution. The dollar limit is indexed for inflation. A similar 15-percent additional estate tax applies to excess retirement accumulations upon the death of the individual. The 15-percent tax on excess distributions (but not the 15-percent additional estate tax) does not apply to distributions in 1997, 1998 or 1999.

IRAs may not be invested in collectibles. A collectible is defined as any piece of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or other personal property as specified by the Treasury. This prohibition does not apply to coins issued by a State.

Reasons for Change

The Committee is concerned about the national savings rate, and believes that individuals should be encouraged to save. The Committee believes that the ability to make deductible contributions to an IRA is a significant savings incentive. However, this incentive is not available to all taxpayers under present law. Further, the present-law income thresholds for IRA deductions are not indexed for inflation so that fewer Americans will be eligible to make a deductible IRA contribution each year. The Committee believes it is appropriate to encourage individual saving and that deductible IRAs should be available to more individuals.

In addition, the Committee believes that some individuals would be more likely to save if funds set aside in a tax-favored account could be withdrawn without tax after a reasonable holding period for retirement or certain special purposes. Some taxpayers may find such a vehicle more suitable for their savings needs.

The Committee believes that providing an incentive to save for certain special purposes is appropriate. The Committee believes that many Americans may have difficulty saving enough to ensure that they will be able to purchase a home. Home ownership is a fundamental part of the American dream.

The Committee believes that individuals who are unemployed for a substantial period of time should have access to their retirement savings.

The Committee believes that the present-law rules relating to deductible IRAs penalize American homemakers. The Committee believes that an individual should not be precluded from making a deductible IRA contribution merely because his or her spouse participates in an employer-sponsored retirement plan.

Finally, the Committee believes that IRAs should not be precluded from investing in bullion.

Explanation of Provision

In general

The bill (1) increases the AGI phase-out limits for deductible IRAs, (2) provides that an individual is not considered an active participant in an IRA merely because the individual's spouse is an active participant, (3) provides an exception from the early withdrawal tax for withdrawals for first-time home purchase (up to $10,000) and long-term unemployed individuals, and (4) replaces present-law nondeductible IRAs with a new IRA called the IRA Plus. All individuals may make nondeductible contributions of up to $2,000 annually to an IRA Plus. No income limitations apply to IRA Plus accounts; however, the $2,000 maximum contribution limit is reduced to the extent an individual makes deductible contributions to an IRA. An IRA Plus is an IRA which is designated at the time of establishment as an IRA Plus in the manner prescribed by the Secretary. Qualified distributions from an IRA Plus are not includible in income.

Increase income phase-out ranges for deductible IRAs

The bill increases the AGI phase-out range for deductible IRA contributions as follows:

[In thousands of dollars]

Taxable years beginning in:	Phase-Out Range	
	Single Taxpayers	Joint Returns
1998 and 1999	30,000–40,000	50,000–60,000
2000 and 2001	35,000–45,000	60,000–70,000
2002 and 2003	40,000–50,000	70,000–80,000
2004 and thereafter	50,000–60,000	80,000–100,000

Active participant rule

The bill provides that an individual is not considered an active participant in an employer-sponsored plan merely because the individual's spouse is an active participant.

Modifications to early withdrawal tax

The bill provides that the 10-percent early withdrawal tax does not apply to withdrawals from an IRA (including an IRA Plus) for (1) up to $10,000 of first-time homebuyer expenses and (2) distributions for long-term unemployed individuals.[27]

Under the bill, qualified first-time homebuyer distributions are withdrawals of up to $10,000 during the individual's lifetime that are used within 120 days to pay costs (including reasonable settlement, financing, or other closing costs) of acquiring, constructing, or reconstructing the principal residence of a first-time homebuyer who is the individual, the individual's spouse, or a child, grandchild, or ancestor of the individual or individual's spouse. A first-time homebuyer is an individual who has not had an ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which the withdrawal relates. The bill requires that the spouse of the individual also meet this requirement as of the date the contract is entered into or construction commences. The date of acquisition is the date the individual enters into a binding contract to purchase a principal residence or begins construction or reconstruction of such a residence. Principal residence is defined as under the provisions relating to the rollover of gain on the sale of a principal residence.

Under the bill, any amount withdrawn for the purchase of a principal residence is required to be used within 120 days of the date of withdrawal. The 10-percent additional income tax on early withdrawals is imposed with respect to any amount not so used. If the 120-day rule cannot be satisfied due to a delay in the acquisition of the residence, the taxpayer may recontribute all or part of the amount withdrawn to an IRA Plus prior to the end of the 120-day period without adverse tax consequences.

Under the bill, the 10-percent early withdrawal tax does not apply to distributions to an individual after separation from em-

[27] The bill also provides for penalty-free withdrawals from IRAs for education expenses (see above).

ployment if the individual has received unemployment compensation for 12 consecutive weeks under any Federal or State unemployment compensation law and the distribution is made during any taxable year during which the unemployment compensation is paid or the succeeding taxable year. This exception does not apply to any distribution made after the individual has been employed for at least 60 days after the separation of employment. To the extent provided in regulations, the provision applies to a self-employed individual if, under Federal or State law, the individual would have received unemployment compensation but for the fact the individual was self employed.

IRA investments in bullion

Under the bill, IRA assets may be invested in certain bullion. The bill applies to any gold, silver, platinum or palladium bullion of a fineness equal to or exceeding the minimum fineness required for metals which may be delivered in satisfaction of a regulated futures contract subject to regulation by the Commodity Futures Trading Commission. The provision does not apply unless the bullion is in the physical possession of the IRA trustee.[28]

IRA Plus accounts

Contributions to IRA Plus accounts

The maximum annual contribution that may be made to an IRA Plus is the lesser of $2,000 (reduced by deductible IRA contributions) or the individual's compensation for the year. As under the present-law rules relating to deductible IRAs, a contribution of up to $2,000 for each spouse may be made to an IRA Plus provided the combined compensation of the spouses is at least equal to the contributed amount.

Contributions to an IRA Plus may be made even after the individual for whom the account is maintained has attained age 70½.

Taxation of distributions

Qualified distributions from an IRA Plus are not includible in gross income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the 5-taxable year period beginning with the first taxable year in which the individual made a contribution to an IRA Plus,[29] and (2) which is (a) made on or after the date on which the individual attains age 59½, (b) made to a beneficiary (or to the individual's estate) on or after the death of the individual, (c) attributable to the individual's being disabled, or (d) a qualified special purpose distribution. Qualified special purpose distributions are distributions that are exempt from the 10-percent early withdrawal tax because they are for first-time homebuyer expenses or long-term unemployed individuals.

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[28] The bill does not modify the present-law rule permitting IRAs to be invested in certain State coins.

[29] As is the case with IRAs generally, contributions to an IRA Plus may be made for a year by the due date for the individual's tax return for the year (determined without regard to extensions). In the case of a contribution to an IRA Plus made after the end of the taxable year, the 5-year holding period begins with the taxable year to which the contribution relates, rather than the year in which the contribution is actually made.

Distributions from an IRA Plus that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to IRA Plus accounts.

An ordering rule applies for purposes of determining what portion of a distribution that is not a qualified distribution is includible in income. Under the ordering rule, distributions from an IRA Plus are treated as made from contributions first, and all an individual's IRA Plus accounts are treated as a single IRA Plus. Thus, no portion of a distribution from an IRA Plus is treated as attributable to earnings (and therefore includible in gross income) until the total of all distributions from all the individual's IRA Plus accounts exceeds the amount of contributions.

Distributions from an IRA Plus may be rolled over tax free to another IRA Plus.

Conversions of an IRA to an IRA Plus

All or any part of amounts in a present-law deductible or nondeductible IRA may be converted into an IRA Plus. If the conversion is made before January 1, 1999, the amount that would have been includible in gross income if the individual had withdrawn the converted amounts is included in gross income ratably over the 4-taxable year period beginning with the taxable year in which the conversion is made. The early withdrawal tax does not apply to such conversions.[30]

A conversion of an IRA into an IRA Plus can be made in a variety of different ways and without taking a distribution. For example, an individual may make a conversion simply by notifying the IRA trustee. Or, an individual may make the conversion in connection with a change in IRA trustees through a rollover or a trustee-to-trustee transfer. If a part of an IRA balance is converted into an IRA Plus, the IRA Plus amounts may have to be held separately.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

B. Capital Gains Provisions

1. Maximum rate of tax on net capital gain of individuals (sec. 311 of the bill and sec. 1(h) of the Code)

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain is taxed at the same rate as ordinary income, except that individuals are subject to a maximum marginal rate of 28 percent of the net capital gain. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term cap-

[30] In the case of conversions from an IRA to an IRA Plus, the 5-taxable year holding period begins with the taxable year in which the conversion was made.

ital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

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

Reasons for Change

The Committee believes it is important that tax policy be conducive to economic growth. Economic growth cannot occur without saving, investment, and the willingness of individuals to take risks. The greater the pool of savings, the greater the monies available for business investment. It is through such investment that the United States' economy can increase output and productivity. It is through increases in productivity that workers earn higher real wages. Hence, greater saving is necessary for all Americans to benefit through a higher standard of living.

The Committee believes that, by reducing the effective tax rates on capital gains, American households will respond by increasing saving. The Committee believes it is important to encourage risk taking and believes a reduction in the taxation of capital gains will have that effect. The Committee also believes that a reduction in the taxation of capital gains will improve the efficiency of the capital markets, because the taxation of capital gains upon realization encourages investors who have accrued past gains to keep their monies "locked in" to such investment even when better investment opportunities present themselves. A reduction in the taxation of capital gains should reduce this "lock in" effect.

Explanation of Provision

Under the bill, the maximum rate of tax on the net capital gain of an individual is reduced from 28 percent to 20 percent. In addition, any net capital gain which otherwise would be taxed at a 15 percent rate is taxed at a 10 percent rate. These rates apply for purposes of both the regular tax and the minimum tax.

The tax on the net capital gain attributable to any long-term gain from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof) will remain at 28 percent; and any gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) to the extent of the gain that would have been treated as ordinary income if the property had been section 1245 property will be taxed at a maximum rate of 24 percent.

Effective Date

The provision applies to taxable years ending after May 6, 1997.

For a taxpayer's taxable year that includes May 7, 1997, the lower rates will not apply to an amount equal to the net capital gain determined by including only gain or loss properly taken into account for the portion of the year before May 7, 1997. This generally has the effect of applying the lower rates to capital assets sold or exchanged (or installment payments received) on or after May 7, 1997, and subjecting the remaining portion of the net capital gain to a maximum rate of 28 percent.

In the case of gain taken into account by a pass-through entity (i.e., a RIC, a REIT, a partnership, an estate or trust, or a common trust fund), the date taken into account by the entity is the appropriate date for applying the rule in the preceding paragraph to the individual taxpayer's taxable year which includes May 7, 1997.

2. Small business stock (secs. 312 and 313 of the bill and secs. 1045 and 1202 of the Code)

Present Law

The Revenue Reconciliation Act of 1993 provided individuals a 50-percent exclusion for the sale of certain small business stock acquired at original issue and held for at least five years. One-half of the excluded gain is a minimum tax preference.

The amount of gain eligible for the 50-percent exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million.

In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet an active trade or business requirement.

Reasons for Change

The Committee believes it is important to maintain a larger exclusion for stock in small, start-up enterprises. Such enterprises are inherently risky and may not have easy access to the capital necessary to launch a new venture. The Committee believes that it is important to foster such entrepreneurial activities and believes targeted reduction in capital gains taxation will help provide access to needed capital.

The Committee also understands that the present law restrictions on working capital may often be inappropriate in the context of a venture start up enterprise.

Explanation of Provision

Under the bill, the 50-percent exclusion will apply to small business stock (other than stock of a subsidiary corporation) held by a corporation. The minimum tax preference is repealed. Under the bill, in the case of a qualifying sale of small business stock by an individual, the maximum rate of tax (taking together the 50-percent exclusion and the maximum 20-percent capital gains rate added by the bill) will be 10 percent.

The bill increases the size of an eligible corporation from gross assets of $50 million to gross assets of $100 million. The bill also repeals the limitation on the amount of gain a taxpayer can exclude with respect to the stock of any corporation.

The bill provides that certain working capital must be expended within five years (rather than two years) in order to be treated as used in the active conduct of a trade or business. No limit on the percent of the corporation's assets that are working capital is imposed.

The bill provides that if the corporation establishes a business purpose for a redemption of its stock, that redemption is disregarded in determining whether other newly issued stock could qualify as eligible stock.

The bill allows a taxpayer to roll over gain from the sale or exchange of small business stock otherwise qualifying for the exclusion where the taxpayer uses the proceeds to purchase other qualifying small business stock within 60 days of the sale of the original stock. If the taxpayer sells the replacement stock, the gain attributable to the original stock is eligible for the small business stock exclusion and the capital gain rates, and any remaining gain is eligible for the capital gain rates if held more than one year and the small business exclusion if held for at least five years. In addition, any gain that otherwise would be recognized from the sale of the replacement stock can be rolled over to other small business stock purchased within 60 days.

Effective Date

The increase in the size of corporations whose stock is eligible for the exclusion and the provisions applicable to corporate shareholders applies to stock issued after the date of the enactment of the proposal. The remaining provisions apply to stock issued after August 10, 1993 (the original effective date of the small business stock provision).

3. Exclusion of gain on sale of principal residence (sec. 314 of the bill and secs. 121 and 1034 of the Code)

Present Law

Rollover of gain

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule.

One-time exclusion

In general, an individual, on a one-time basis, may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has owned the property and used it as a principal residence for three or more of the five years preceding the sale (sec. 121).

Reasons for Change

Calculating capital gain from the sale of a principal residence is among the most complex tasks faced by a typical taxpayer. Many taxpayers buy and sell a number of homes over the course of a lifetime, and are generally not certain of how much housing appreciation they can expect. Thus, even though most homeowners never pay any income tax on the capital gain on their principal residences, as a result of the rollover provisions and the $125,000 one-time exclusion, detailed records of transactions and expenditures on home improvements must be kept, in most cases, for many decades. To claim the exclusion, many taxpayers must determine the basis of each home they have owned, and appropriately adjust the basis of their current home to reflect any untaxed gains from previous housing transactions. This determination may involve augmenting the original cost basis of each home by expenditures on improvements. In addition to the record-keeping burden this creates, taxpayers face the difficult task of drawing a distinction between improvements that add to basis, and repairs that do not. The failure to account accurately for all improvements leads to errors in the calculation of capital gains, and hence to an under- or overpayment of the capital gains on principal residences. By excluding from taxation capital gains on principal residences below a relatively high threshold, few taxpayers would have to refer to records in determining income tax consequences of transactions related to their house.

To postpone the entire capital gain from the sale of a principal residence, the purchase price of a new home must be greater than the sales price of the old home. This provision of present law encourages some taxpayers to purchase larger and more expensive houses than they otherwise would in order to avoid a tax liability, particularly those who move from areas where housing costs are high to lower-cost areas. This promotes an inefficient use of taxpayer's financial resources.

Present law also may discourage some older taxpayers from selling their homes. Taxpayers who would realize a capital gain in excess of $125,000 if they sold their home and taxpayers who have already used the exclusion may choose to stay in their homes even though the home no longer suits their needs. By raising the $125,000 limit and by allowing multiple exclusions, this constraint to the mobility of the elderly would be removed.

While most homeowners do not pay capital gains tax when selling their homes, current law creates certain tax traps for the unwary that can result in significant capital gains taxes or loss of the benefits of the current exclusion. For example, an individual is not eligible for the one-time capital gains exclusion if the exclusion was previously utilized by the individual's spouse. This restriction has the unintended effect of penalizing individuals who marry someone who has already taken the exclusion. Households that move from a high housing-cost area to a low housing-cost area may incur an unexpected capital gains tax liability. Divorcing couples may incur substantial capital gains taxes if they do not carefully plan their house ownership and sale decisions.

Explanation of Provision

Under the bill a taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years. The bill provides that gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after May 6, 1997.

To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or unforseen circumstances is able to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 is available on a qualifying sale or exchange of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the bill would allow the newly married taxpayer a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude $500,000 of gain on their joint return.

Under the bill, the gain from the sale or exchange of the remainder interest in the taxpayer's principal residence may qualify for the otherwise allowable exclusion.

Effective Date

The provision is available for all sales or exchanges of a principal residence occurring on or after May 7, 1997, and replaces the present-law rollover and one-time exclusion provisions applicable to principal residences.

A taxpayer may elect to apply present law (rather than the new exclusion) to a sale or exchange (1) made before the date of enactment of the Act, (2) made after the date of enactment pursuant to a binding contract in effect on the date or (3) where the replacement residence was acquired on or before the date of enactment (or pursuant to a binding contract in effect of the date of enactment) and the rollover provision would apply. If a taxpayer acquired his or her current residence in a rollover transaction, periods of ownership and use of the prior residence would be taken into account in determining ownership and use of the current residence.

TITLE IV. ESTATE, GIFT, AND GENERATION-SKIPPING TAX PROVISIONS

A. Increase in Estate and Gift Tax Unified Credit (sec. 401(a) of the bill and sec. 2010 of the Code)

Present Law

A gift tax is imposed on lifetime transfers by gift and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.[31] A unified credit of $192,800 is provided against the estate and gift tax, which effectively exempts the first $600,000 in cumulative taxable transfers from tax (sec. 2010). For transfers in excess of $600,000, estate and gift tax rates begin at 37 percent and reach 55 percent on cumulative taxable transfers over $3 million (sec. 2001(c)). In addition, a 5-percent surtax is imposed upon cumulative taxable transfers between $10 million and $21,040,000, to phase out the benefits of the graduated rates and the unified credit (sec. 2001(c)(2)).[32]

Reasons for Change

The Committee believes that increasing the amount of the estate and gift tax unified credit will encourage saving, promote capital formation and entrepreneurial activity, and help to preserve existing family-owned farms and businesses. The Committee further believes that indexing the unified credit exemption equivalent amount for inflation is appropriate to reduce the transfer tax consequences that result from increases in asset value attributable solely to inflation.

Explanation of Provision

The bill increases the present-law unified credit beginning in 1998, from an effective exemption of $600,000 to an effective exemption of $1,000,000 in 2006. The increase in the effective exemption is phased in according to the following schedule: the effective exemption is $625,000 for decedents dying and gifts made in 1998; $640,000 in 1999; $660,000 in 2000; $675,000 in 2001; $725,000 in 2002; $750,000 in 2003; $800,000 in 2004; $900,000 in 2005; and $1 million in 2006. After 2006, the effective exemption is indexed annually for inflation. The indexed exemption amount is rounded to the next lowest multiple of $10,000.

Conforming amendments to reflect the increased unified credit are made (1) to the 5-percent surtax to conform the phase out of the increased unified credit and graduated rates, (2) to the general filing requirements for an estate tax return under section 6018(a), and (3) to the amount of the unified credit allowed under section 2102(c)(3) with respect to nonresident aliens with U.S. situs property who are residents of certain treaty countries.

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[31] Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

[32] Thus, if a taxpayer has made cumulative taxable transfers equaling $21,040,000 or more, his or her average transfer tax rate is 55 percent. The phaseout has the effect of creating a 60-percent marginal transfer tax rate on transfers in the phaseout range.

Effective Date

The provision is effective for decedents dying, and gifts made, after December 31, 1997.

B. Indexing of Certain Other Estate and Gift Tax Provisions (sec. 401 (b)–(e) of the bill and secs. 2032A, 2503, 2631, and 6601(j) of the Code)

Present Law

Annual exclusion for gifts.—A taxpayer may exclude $10,000 of gifts of present interests in property made by an individual ($20,000 per married couple) to each donee during a calendar year (sec. 2503).

Special use valuation.—An executor may elect for estate tax purposes to value certain qualified real property used in farming or a closely-held trade or business at its current use value, rather than its "highest and best use" value (sec. 2032A). The maximum reduction in value under such an election is $750,000.

Generation-skipping transfer ("GST") tax.—An individual is allowed an exemption from the GST tax of up to $1,000,000 for generation-skipping transfers made during life or at death (sec. 2631).

Installment payment of estate tax.—An executor may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period (sec. 6166). The tax on the first $1,000,000 in value of a closely-held business is eligible for a special 4-percent interest rate (sec. 6601(j)).

Reasons for Change

The Committee believes that it is appropriate to index for inflation the annual exclusion for gifts, the ceiling on special use valuation, the generation-skipping transfer tax exemption, and the ceiling on the value of a closely-held business eligible for the special low interest rate, to reduce the transfer tax consequences that result from increases in asset value attributable solely to inflation.

Explanation of Provision

The bill provides that, after 1998, the $10,000 annual exclusion for gifts, the $750,000 ceiling on special use valuation, the $1,000,000 generation-skipping transfer tax exemption, and the $1,000,000 ceiling on the value of a closely-held business eligible for the special low interest rate (as modified below), are indexed annually for inflation. Indexing of the annual exclusion is rounded to the next lowest multiple of $1,000 and indexing of the other amounts is rounded to the next lowest multiple of $10,000.

Effective Date

The provision is effective for decedents dying, and gifts made, after December 31, 1998.

C. Estate Tax Exclusion for Qualified Family-Owned Businesses (sec. 402 of the bill and new sec. 2033A of the Code)

Present Law

There are no special estate tax rules for qualified family-owned businesses. All taxpayers are allowed a unified credit in computing the taxpayer's estate and gift tax, which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax (sec. 2010). An executor also may elect, under section 2032A, to value certain qualified real property used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value (up to a maximum reduction of $750,000). In addition, an executor may elect to pay the Federal estate tax attributable to a qualified closely-held business in installments over, at most, a 14-year period (sec. 6166). The tax attributable to the first $1,000,000 in value of a closely-held business is eligible for a special 4-percent interest rate (sec. 6601(j)).

Reasons for Change

The Committee believes that a reduction in estate taxes for qualified family-owned businesses will protect and preserve family farms and other family-owned enterprises, and prevent the liquidation of such enterprises in order to pay estate taxes. The Committee further believes that the protection of family enterprises will preserve jobs and strengthen the communities in which such enterprises are located.

Explanation of Provision

The bill allows an executor to elect special estate tax treatment for qualified "family-owned business interests" if such interests comprise more than 50 percent of a decedent's estate and certain other requirements are met. In general, the provision excludes the first $1 million of value in qualified family-owned business interests from a decedent's taxable estate.

This new exclusion for qualified family-owned business interests is provided in addition to the unified credit (which presently effectively exempts $600,000 of taxable transfers from the estate and gift tax, and will be increased to an effective exemption of $1,000,000 of taxable transfers under other provisions of the bill), the special-use provisions of section 2032A (which permit the exclusion of up to $750,000 in value of a qualifying farm or other closely-held business from a decedent's estate), and the provisions of section 6166 (which provide for the installment payment of estate taxes attributable to closely held businesses).

Qualified family-owned business interests

For purposes of the bill, a qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. Under the provision, members of an individual's family are defined using the same definition as is used for the special-use valuation rules of section 2032A, and thus include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants. For purposes of applying the ownership tests in the case of a corporation, the decedent and members of the decedent's family are required to own the requisite percentage of the total combined voting power of all classes of stock entitled to vote *and* the requisite percentage of the total value of all shares of all classes of stock of the corporation. In the case of a partnership, the decedent and members of the decedent's family are required to own the requisite percentage of the capital interest, and the requisite percentage of the profits interest, in the partnership.

In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special look-through rules apply. Each trade or business owned (directly or indirectly) by the decedent and members of the decedent's family is separately tested to determine whether that trade or business meets the requirements of a qualified family-owned business interest. In applying these tests, any interest that a trade or business owns in another trade or business is disregarded in determining whether the first trade or business is a qualified family-owned business interest. The value of any qualified family-owned business interest held by an entity is treated as being proportionately owned by or for the entity's partners, shareholders, or beneficiaries. In the case of a multi-tiered entity, such rules are sequentially applied to look through each separate tier of the entity.

For example, if a holding company owns interests in two other companies, each of the three entities will be separately tested under the qualified family-owned business interest rules. In determining whether the holding company is a qualified family-owned business interest, its ownership interest in the other two companies is disregarded. Even if the holding company itself does not qualify as a family-owned business interest, the other two companies still may qualify if the direct and indirect interests held by the decedent and his or her family members satisfy the requisite ownership percentages and other requirements of a qualified family-owned business interest. If either (or both) of the lower-tier entities qualify, the value of the qualified family-owned business interests owned by the holding company are treated as proportionately owned by the holding company's shareholders.

An interest in a trade or business does not qualify if the business's (or a related entity's) stock or securities were publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income (as defined in section 543). This personal holding company restriction does not apply to banks or domestic building and loan associations.

The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities. Under the bill, the value of qualified family-owned business interests does not include any cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business. For this purpose, it is intended that day-to-day working capital needs be determined based on a historical average of the business's working capital needs in the past, using an analysis similar to that set forth in *Bardahl Mfg. Corp.,* 24 T.C.M. 1030 (1965). It is further intended that accumulations for capital acquisitions not be considered "working capital" for this purpose. The value of the qualified family-owned business interests also does not include certain other passive assets. For this purpose, passive assets include any assets that (a) produce dividends, interest, rents, royalties, annuities and certain other types of passive income (as described in sec. 543(a)); (b) are an interest in a trust, partnership or REMIC (as described in sec. 954(c)(1)(B)(ii)); (c) produce no income (as described in sec. 954(c)(1)(B)(iii)); (d) give rise to income from commodities transactions or foreign currency gains (as described in sec. 954(c)(1) (C) and (D)); (e) produce income equivalent to interest (as described in sec. 954(c)(1)(E)); or (f) produce income from notional principal contracts or payments in lieu of dividends (as described in new secs. 954(c)(1) (F) and (G), added elsewhere in the bill). In the case of a regular dealer in property, such property is not considered to produce passive income under these rules, and thus, is not considered to be a passive asset.

Qualifying estates

A decedent's estate qualifies for the special treatment only if the decedent was a U.S. citizen or resident at the time of death, and the aggregate value of the decedent's qualified family-owned business interests that are passed to qualified heirs exceeds 50 percent of the decedent's adjusted gross estate (the "50-percent liquidity test"). For this purpose, qualified heirs include any individual who has been actively employed by the trade or business for at least 10 years prior to the date of the decedent's death, and members of the decedent's family. If a qualified heir is not a citizen of the United States, any qualified family-owned business interest acquired by that heir must be held in a trust meeting requirements similar to those imposed on qualified domestic trusts (under present-law sec. 2056A(a)), or through certain other security arrangements that meet the satisfaction of the Secretary. The 50-percent liquidity test generally is applied by adding all transfers of qualified family-owned business interests made by the decedent to qualified heirs at the time of the decedent's death, plus certain lifetime gifts of qualified family-owned business interests made to members of the decedent's family, and comparing this total to the decedent's adjusted gross estate. To the extent that a decedent held qualified family-owned business interests in more than one trade or business, all such interests are aggregated for purposes of applying the 50-percent liquidity test.

The 50-percent liquidity test is calculated using a ratio, the numerator and denominator of which are described below.

The numerator is determined by aggregating the value of all qualified family-owned business interests that are includible in the decedent's gross estate and are passed from the decedent to a qualified heir, plus any lifetime transfers of qualified business interests that are made by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests have been continuously held by members of the decedent's family and were not otherwise includible in the decedent's gross estate. For this purpose, qualified business interests transferred to members of the decedent's family during the decedent's lifetime are valued as of the date of such transfer. This amount is then reduced by all indebtedness of the estate, except for the following: (a) indebtedness on a qualified residence of the decedent (determined in accordance with the requirements for deductibility of mortgage interest set forth in section 163(h)(3)); (b) indebtedness incurred to pay the educational or medical expenses of the decedent, the decedent's spouse or the decedent's dependents; (c) other indebtedness of up to $10,000.

The denominator is equal to the decedent's gross estate, reduced by any indebtedness of the estate, and increased by the amount of the following transfers, to the extent not already included in the decedent's gross estate: (a) any lifetime transfers of qualified business interests that were made by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests have been continuously held by members of the decedent's family, plus (b) any other transfers from the decedent to the decedent's spouse that were made within 10 years of the date of the decedent's death, plus (c) any other transfers made by the decedent within three years of the decedent's death, except non-taxable transfers made to members of the decedent's family. The Secretary of Treasury is granted authority to disregard de minimis gifts. In determining the amount of gifts made by the decedent, any gift that the donor and the donor's spouse elected to have treated as a split gift (pursuant to sec. 2513) is treated as made one-half by each spouse for purposes of this provision.

Participation requirements

To qualify for the beneficial treatment provided under the bill, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, each qualified heir (or a member of the qualified heir's family) is required to materially participate in the trade or business for at least five years of any eight-year period within ten years following the decedent's death. For this purpose, "material participation" is defined as under present-law section 2032A (special use valuation) and the regulations promulgated thereunder. See, e.g., Treas. Reg. sec. 20.2032A-3. Under such regulations, no one factor is determinative of the presence of material participation and the uniqueness of the particular industry (e.g., timber, farming, manufacturing, etc.) must be considered. Physical work and participation in management decisions are the principal factors to be considered. For example, an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed.

If a qualified heir rents qualifying property to a member of the qualified heir's family on a net cash basis, and that family member materially participates in the business, the material participation requirement will be considered to have been met with respect to the qualified heir for purposes of this provision.

Recapture provisions

The benefit of the exclusions for qualified family-owned business interests are subject to recapture if, within 10 years of the decedent's death and before the qualified heir's death, one of the following "recapture events" occurs: (1) the qualified heir ceases to meet the material participation requirements (i.e., if neither the qualified heir nor any member of his or her family has materially participated in the trade or business for at least five years of any eight-year period); (2) the qualified heir disposes of any portion of his or her interest in the family-owned business, other than by a disposition to a member of the qualified heir's family or through a conservation contribution under section 170(h); (3) the principal place of business of the trade or business ceases to be located in the United States; or (4) the qualified heir loses U.S. citizenship. A qualified heir who loses U.S. citizenship may avoid such recapture by placing the qualified family-owned business assets into a trust meeting requirements similar to a qualified domestic trust (as described in present law section 2056A(a)), or through certain other security arrangements.

If one of the above recapture events occurs, an additional tax is imposed on the date of such event. As under section 2032A, each qualified heir is personally liable for the portion of the recapture tax that is imposed with respect to his or her interest in the qualified family-owned business. Thus, for example, if a brother and sister inherit a qualified family-owned business from their father, and only the sister materially participates in the business, her participation will cause both her and her brother to meet the material participation test. If she ceases to materially participate in the business within 10 years after her father's death (and the brother still does not materially participate), the sister and brother would both be liable for the recapture tax; that is, each would be liable for the recapture tax attributable to his or her interest.

The portion of the reduction in estate taxes that is recaptured would be dependent upon the number of years that the qualified heir (or members of the qualified heir's family) materially participated in the trade or business after the decedent's death. If the qualified heir (or his or her family members) materially participated in the trade or business after the decedent's death for less than six years, 100 percent of the reduction in estate taxes attributable to that heir's interest is recaptured; if the participation was for at least six years but less than seven years, 80 percent of the reduction in estate taxes is recaptured; if the participation was for at least seven years but less than eight years, 60 percent is recaptured; if the participation was for at least eight years but less than nine years, 40 percent is recaptured; and if the participation was for at least nine years but less than ten years, 20 percent of the reduction in estates taxes is recaptured. In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. As under present-law section 2032A, however, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

If a recapture event occurs with respect to any qualified family-owned business interest (or portion thereof), the amount of reduction in estate taxes attributable to that interest is determined on a proportionate basis. For example, if the decedent's estate included $2 million in qualified family-owned business interests and $1 million of such interests received beneficial treatment under this proposal, one-half of the value of the interest disposed of is deemed to have received the benefits provided under this proposal.

Effective Date

The provision is effective with respect to the estates of decedents dying after December 31, 1997.

D. Reduction in Estate Tax for Certain Land Subject to Permanent Conservation Easement (sec. 403 of the bill and sec. 2031 of the Code)

Present Law

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). A "conservation purpose" is (1) preservation of land for outdoor recreation by, or the education of, the general public, (2) preservation of natural habitat, (3) preservation of open space for scenic enjoyment of the general public or pursuant to a governmental conservation policy, and (4) preservation of historically important land or certified historic structures. Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.[33]

A donor making a qualified conservation contribution generally is not allowed to retain an interest in minerals which may be extracted or removed by any surface mining method. However, deductions for contributions of conservation interests satisfying all of the above requirements will be permitted if two conditions are satisfied. First, the surface and mineral estates in the property with respect to which the contribution is made must have been separated before June 13, 1976 (and remain so separated) and, second, the probability of surface mining on the property with respect to which a contribution is made must be so remote as to be negligible (sec. 170(h)(5)(B)).

[33] A member of the transferor's family includes: (1) his or her ancestors; (2) his or her spouse; (3) a lineal descendant of the decedent, the decedent's spouse or the decedent's parents; and (4) the spouse of any of the foregoing lineal descendants.

The same definition of qualified conservation contributions also applies for purposes of determining whether such contributions qualify as charitable deductions for income tax purposes.

Reasons for Change

The Committee believes that a reduction in estate taxes for land subject to a qualified conservation easement will ease existing pressures to develop or sell off open spaces in order to raise funds to pay estate taxes, and will thereby help to preserve environmentally significant land.

Explanation of Provision

Reduction in estate taxes for certain land subject to permanent conservation easement

The provision allows an executor to elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of section 170(h)) of a qualified real property interest (as generally defined in section 170(h)(2)(C)) was granted by the transferor or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Debt-financed property is not eligible for the exclusion.

The exclusion amount is calculated based on the value of the property after the conservation easement has been placed on the property. The exclusion from estate taxes does not extend to the value of any development rights retained by the decedent or donor, although payment for estate taxes on retained development rights may be deferred for up to two years, or until the disposition of the property, whichever is earlier. For this purpose, retained development rights are any rights retained to use the land for any commercial purpose which is not subordinate to and directly supportive of farming purposes, as defined in section 6420 (e.g., tree farming, ranching, viticulture, and the raising of other agricultural or horticultural commodities).

Maximum benefit allowed

The 40-percent estate tax exclusion for land subject to a qualified conservation easement (described above) may be taken only to the extent that the total exclusion for qualified conservation easements, plus the exclusion for qualified family-owned business interests (described in C., above), does not exceed $1 million. The executor of an estate holding land subject to a qualified conservation easement and/or qualified family-owned business interests is required to designate which of the two benefits is being claimed with respect to each property on which a benefit is claimed.

If the value of the conservation easement is less than 30 percent of (a) the value of the land without the easement, reduced by (b) the value of any retained development rights, then the exclusion percentage is reduced. The reduction in the exclusion percentage is equal to two percentage points for each point that the above ratio falls below 30 percent. Thus, for example, if the value of the easement is 25 percent of the value of the land before the easement less the value of the retained development rights, the exclusion percentage is 30 percent (i.e., the 40 percent amount is reduced by twice the difference between 30 percent and 25 percent). Under this calculation, if the value of the easement is 10 percent or less of the value of the land before the easement less the value of the retained development rights, the exclusion percentage is equal to zero.

Treatment of land subject to a conservation easement for purposes of special-use valuation

The granting of a qualified conservation easement (as defined above) is not treated as a disposition triggering the recapture provisions of section 2032A. In addition, the existence of a qualified conservation easement does not prevent such property from subsequently qualifying for special-use valuation treatment under section 2032A.

Retained mineral interests

The provision also allows a charitable deduction (for income tax purposes or estate tax purposes) to taxpayers making a contribution of a permanent conservation easement on property where a mineral interest has been retained and surface mining is possible, but its probability is "so remote as to be negligible." Present law provides for a charitable deduction in such a case if the mineral interests have been separated from the land prior to June 13, 1976. The provision allows such a charitable deduction to be taken regardless of when the mineral interests had been separated.

Effective Date

The estate tax exclusion applies to decedents dying after December 31, 1997. The rules with respect to the treatment of conservation easements under section 2032A and with respect to retained mineral interests are effective for easements granted after December 31, 1997.

E. Installment Payments of Estate Tax Attributable to Closely Held Businesses (secs. 404 and 405 of the bill and secs. 6601(j) and 6166 of the Code)

Present Law

In general, the Federal estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate may pay only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest generally is imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short-term rate plus 3 percentage points). Under section 6601(j), however, a special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business.

To qualify for the installment payment election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. An interest in a closely held business includes: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners, or if at least 20 percent of the partnership's assets are included in determining the decedent's gross estate; or (3) stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20 percent of the value of the voting stock is included in determining the decedent's gross estate.

Reasons for Change

The Committee believes that the installment payment provisions need to be expanded in order to better address the liquidity problems of estates holding farms and closely held businesses, to prevent the liquidation of such businesses in order to pay estate taxes. The Committee further believes that the protection of closely held businesses will preserve jobs and strengthen the communities in which such businesses are located.

In addition, by eliminating the deductibility of interest paid on estate taxes deferred under section 6166 (and reducing the interest rate accordingly), the bill eliminates the need to file annual supplemental estate tax returns and make complex iterative computations to claim an estate tax deduction for interest paid.

Explanation of Provision

The bill extends the period for which Federal estate tax installments may be made under section 6166 to a maximum period of 24 years. If the election is made, the estate pays only interest for the first four years, followed by up to 20 annual installments of principal and interest.

In addition, the bill provides that no interest is imposed on the amount of deferred estate tax attributable to the first $1,000,000 in taxable value of the closely held business (i.e., the first $1,000,000 in value in excess of the effective exemption provided by the unified credit and any other exclusions). Thus, for example, in 1998, when the unified credit is increased to provide an effective exemption of $625,000 (as described above), if the business also qualifies for the new $1 million exclusion for qualified family-owned business interests (as described above), and the executor so elects, the amount of estate tax attributable to the value of the closely held business between $1,625,000 and $2,625,000 would be eligible for the zero-percent interest rate.

The interest rate imposed on the amount of deferred estate tax attributable to the taxable value of the closely held business in excess of $1,000,000 is reduced to an amount equal to 45 percent of the rate applicable to underpayments of tax. The interest paid on estate taxes deferred under section 6166 is not deductible for estate or income tax purposes.

Effective Date

The provision is effective for decedents dying after December 31, 1997.

F. Estate Tax Recapture from Cash Leases of Specially-Valued Property (sec. 406 of the bill and sec. 2032A of the Code)

Present Law

A Federal estate tax is imposed on the value of property passing at death. Generally, such property is included in the decedent's estate at its fair market value. Under section 2032A, the executor may elect to value certain "qualified real property" used in farming or other qualifying trade or business at its current use value rather than its highest and best use. If, after the special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special-use valuation (sec. 2032A(c)).

Some courts have held that cash rental of specially-valued property after the death of the decedent is not a qualified use under section 2032A because the heirs no longer bear the financial risk of working the property, and, therefore, results in the imposition of the additional estate tax under section 2032A(c). See *Martin* v. *Commissioner*, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party not qualified use); *Williamson* v. *Commissioner*, 93 T.C. 242 (1989), *aff'd*, 974 F.2d 1525 (9th Cir. 1992) (cash lease to family member not a qualified use); *Fisher* v. *Commissioner*, 65 T.C.M. 2284 (1993) (cash lease to family member not a qualified use); cf. *Minter* v. *U.S.*, 19 F.3d 426 (8th Cir. 1994) (cash lease to family's farming corporation is qualified use); *Estate of Gavin* v. *U.S.*, 1997 U.S. App. Lexis 10383 (8th Cir. 1997) (heir's option to pay cash rent or 50 percent crop share is qualified use).

With respect to a decedent's surviving spouse, a special rule provides that the surviving spouse will not be treated as failing to use the property in a qualified use solely because the spouse rents the property to a member of the spouse's family on a net cash basis. (sec. 2032A(b)(5)). Under section 2032A, members of an individual's family include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants.

Reasons for Change

The Committee believes that cash leasing of farmland among family members is consistent with the purposes of the special-use valuation rules, which are intended to prevent family farms (and other qualifying businesses) from being liquidated to pay estate taxes in cases where members of the decedent's family continue to participate in the business.

Explanation of Provision

The bill provides that the cash lease of specially-valued real property by a lineal descendant of the decedent to a member of the lineal descendant's family, who continues to operate the farm or closely held business, does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under section 2032A(c).

Effective Date

The provision is effective for cash rentals occurring after December 31, 1976.

G. Modification of Generation-Skipping Transfer Tax for Transfers to Individuals with Deceased Parents (sec. 407 of the bill and sec. 2651 of the Code)

Present Law

Under the "predeceased parent exception," a direct skip transfer to a transferor's grandchild is not subject to the generation-skipping transfer ("GST") tax if the child of the transferor who was the grandchild's parent is deceased at the time of the transfer (sec. 2612(c)(2)). This "predeceased parent exception" to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

Reasons for Change

The Committee believes that a transfer to a collateral relative whose parent is dead should qualify for the predeceased parent exception in situations where the transferor decedent has no lineal heirs, because no motive or opportunity to avoid transfer tax exists. For similar reasons, the Committee believes that transfers to trusts should be permitted to qualify for the predeceased parent exclusion where the parent of the beneficiary is dead at the time that the transfer is first subject to estate or gift tax. The Committee also understands that this treatment will remove a present law impediment to the establishment of charitable lead trusts.

Explanation of Provision

The bill extends the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. For example, the exception applies to a transfer made by an individual (with no living lineal heirs) to a grandniece where the transferor's nephew or niece who is the parent of the grandniece is deceased at the time of the transfer.

In addition, the bill extends the predeceased parent exception (as modified by the change in the preceding paragraph) to taxable terminations and taxable distributions, provided that the parent of the relevant beneficiary was dead at the earliest time that the transfer (from which the beneficiary's interest in the property was established) was subject to estate or gift tax. For example, where a trust was established to pay an annuity to a charity for a term for years with a remainder interest granted to a grandson, the termination of the term for years is not a taxable termination subject to the GST tax if the grandson's parent (who is the son or daughter of the transferor) was deceased at the time the trust was created and the transfer creating the trust was subject to estate or gift tax.

Effective Date

The provision is effective for generation-skipping transfers occurring after December 31, 1997.

TITLE V. EXTENSION OF CERTAIN EXPIRING TAX PROVISIONS

A. Research Tax Credit (sec. 501 of the bill and sec. 41 of the Code)

Present Law

General rule

Section 41 provides for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and generally will not apply to amounts paid or incurred after May 31, 1997.[34]

A 20-percent research tax credit also applied to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) *over* (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation. This separate credit computation is commonly referred to as the "university basic research credit" (see sec. 41(e)).

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.[35]

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[34] When originally enacted, the research tax credit applied to qualified expenses incurred after June 30, 1981. The credit was modified several times and was extended through June 30, 1995. The credit later was extended for the period July 1, 1996, through May 31, 1997 (with a special 11-month extension for taxpayers that elect to be subject to the alternative incremental research credit regime).

[35] The Small Business Job Protection Act of 1996 expanded the definition of "start-up firms" under section 41(c)(3)(B)(I) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.

A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures.

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, research expenditures and gross receipts of the taxpayer are aggregated with research expenditures and gross receipts of certain related persons for purposes of computing any allowable credit (sec. 41(f)(1)). Special rules apply for computing the credit when a major portion of a business changes hands, under which qualified research expenditures and gross receipts for periods prior to the change of ownership of a trade or business are treated as transferred with the trade or business that gave rise to those expenditures and receipts for purposes of recomputing a taxpayer's fixed-base percentage (sec. 41(f)(3)).

Alternative incremental research credit regime

As part of the Small Business Job Protection Act of 1996, taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made only for a taxpayer's first taxable year beginning after June 30, 1996, and before July 1, 1997, and such an election applies to that taxable year and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury. If a taxpayer elects the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, then all qualified research expenses paid or incurred during the first 11 months of such taxable year are treated as qualified research expenses for purposes of computing the taxpayer's credit.

Eligible expenditures

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").[36]

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 (described below) but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors (sec. 41(d)(3)). In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control (sec. 41(d)(4)).

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Relation to deduction

Under section 174, taxpayers may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with a trade or business, notwithstanding the general rule that business expenses to develop or create an asset that has a useful life extending beyond the current year must be capitalized. However, deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

Reasons for Change

Businesses may not find it profitable to invest in some research activities because of the difficulty in capturing the full benefits from the research. Costly technological advances made by one firm are often cheaply copied by its competitors. A research tax credit can help promote investment in research, so that research activities undertaken approach the optimal level for the overall economy. Therefore, the Committee believes that, in order to encourage re-

[36] Under a special rule enacted as part of the Small Business Job Protection Act of 1996, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

search activities, it is appropriate to reinstate the research tax credit.

Explanation of Provision

The research tax credit is extended for 31 months—i.e., generally for the period June 1, 1997, through December 31, 1999.

Under the provision, taxpayers are permitted to elect the alternative incremental research credit regime under section 41(c)(4) for any taxable year beginning after June 30, 1996, and such election will apply to that taxable year and all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

Effective Date

The provision generally is effective for qualified research expenditures paid or incurred during the period June 1, 1997, through December 31, 1999.

A special rule provides that, notwithstanding the general termination date for the research credit of December 31, 1999, if a taxpayer elects to be subject to the alternative incremental research credit regime for its first taxable year beginning after June 30, 1996, and before July 1, 1997, the alternative incremental research credit will be available during the entire 42-month period beginning with the first month of such taxable year—i.e., the equivalent of the 11-month extension provided for by the Small Business Job Protection Act of 1996 *plus* an additional 31-month extension provided for by this bill. However, to prevent taxpayers from effectively obtaining more than 42-months of research credits from the Small Business Job Protection Act of 1996 and this bill, the 42-month period for taxpayers electing the alternative incremental research credit regime is reduced by the number of months (if any) after June 1996 with respect to which the taxpayer claimed research credit amounts under the regular, 20-percent research credit rules.

B. Contributions of Stock to Private Foundations (sec. 502 of the bill and sec. 170(e)(5) of the Code)

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization.[37] However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use

[37] The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)).

by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.[38]

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to May 31, 1997.[39] Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

Reasons for Change

The Committee believes that, to encourage donations to charitable private foundations, it is appropriate to extend the rule that allows a fair market value deduction for certain gifts of appreciated stock to private foundations.

Explanation of Provision

The bill extends the special rule contained in section 170(e)(5) for contributions of qualified appreciated stock made to private foundations during the period June 1, 1997, through December 31, 1999.

Effective Date

The provision is effective for contributions of qualified appreciated stock to private foundations made during the period June 1, 1997, through December 31, 1999.

C. Work Opportunity Tax Credit (sec. 503 of the bill and sec. 51 of the Code)

Present Law

In general

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of seven targeted groups. The credit generally is equal to 35 percent of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period

[38] As part of the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, if a taxpayer makes a gift to charity of property (other than short-term gain, inventory, or other ordinary income or property, or gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim the same fair-market-value deduction for both regular tax and AMT purposes (subject to present-law percentage limitations).

[39] The special rule contained in section 170(e)(5), which was originally enacted in 1984, expired January 1, 1995. The Small Business Job Protection Act of 1996 reinstated the rule for 11 months—for contributions of qualified appreciated stock made to private foundations during the period July 1, 1996, through May 31, 1997.

beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual's vocational rehabilitation plan as under prior law.

Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is $2,100. With respect to qualified summer youth employees, the maximum credit is 35 percent of up to $3,000 of qualified first-year wages, for a maximum credit of $1,050.

The deduction for wages is reduced by the amount of the credit.

Targeted groups eligible for the credit

(1) Families receiving AFDC

An eligible recipient is an individual certified by the designated local employment agency as being a member of a family eligible to receive benefits under AFDC or its successor program for a period of at least nine months part of which is during the 9-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the AFDC or its successor program.

(2) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law, (2) being a member of a family that had an income during the six months before the earlier of the date of determination or the hiring date which on an annual basis is 70 percent or less of the Bureau of Labor Statistics lower living standard, and (3) having a hiring date within one year of release from prison or date of conviction.

(3) High-risk youth

A high-risk youth is an individual certified as being at least 18 but not yet 25 on the hiring date and as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). Qualified wages will not include wages paid or incurred for services performed after the individual moves outside an empowerment zone or enterprise community.

(4) Vocational rehabilitation referral

Vocational rehabilitation referrals are those individuals who have a physical or mental disability that constitutes a substantial handicap to employment and who have been referred to the employer while receiving, or after completing, vocational rehabilitation services under an individualized, written rehabilitation plan under a State plan approved under the Rehabilitation Act of 1973 or under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(5) Qualified summer youth employee

Qualified summer youth employees are individuals: (1) who perform services during any 90-day period between May 1 and September 15, (2) who are certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who have not been an employee of that employer before, and (4) who are certified by the designated local agency as having a principal place of abode within an empowerment zone or enterprise community (as defined under Subchapter U of the Internal Revenue Code). As with high-risk youths, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone or enterprise community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

(6) Qualified veteran

A qualified veteran is a veteran who is a member of a family certified as receiving assistance under: (1) AFDC for a period of at least nine months part of which is during the 12-month period ending on the hiring date, or (2) a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for: (i) the AFDC or its successor program, and (ii) a food stamp program under the Food Stamp Act of 1977, respectively.

Further, a qualified veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(7) Families receiving food stamps

An eligible recipient is an individual aged 18 but not yet 25 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

Minimum employment period

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 400 hours (120 hours in the case of a qualified summer youth employee).

Expiration date

The credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after September 30, 1996, and before October 1, 1997.

Reasons for Change

The Committee believes that this short-term program with modifications will provide the Congress and the Treasury and Labor Departments an opportunity to assess fully the operation and effectiveness of the credit as a hiring incentive. It will also extend application of the credit to a larger group of eligible individuals pending that evaluation.

Explanation of Provision

The bill extends for 22 months the work opportunity tax credit. The bill also modifies the credit in four additional ways. First, the bill modifies the eligibility definition for the AFDC families targeted group. Specifically, under the bill an otherwise eligible member of a family receiving AFDC benefits for any 9-month period (whether or not consecutive) during the 18-month period ending on the hiring date would qualify as a member of this targeted group (this expansion applies whether or not the individual is a qualified veteran). Second, the proposal adds another targeted group to the credit. The new targeted group is persons certified by the designated local agency as receiving certain Supplemental Security Income (SSI) benefits for any month ending within the 60 day period ending on the hiring date. For these purposes, SSI benefits would mean benefits under title XVI of the Social Security Act (including supplemental security income benefits of the type described in section 1616 of such Act or section 212 of Public Law 93–66). Third, the bill reduces the minimum employment period to 120 hours. Finally, the bill modifies the credit percentage so that it is 25% for the first 400 hours and 40% thereafter (assuming the minimum employment period is satisfied with respect to that employee.

Effective Date

The provisions to extend and modify the work opportunity tax credit are effective for wages paid or incurred to qualified individuals who begin work for the employer after September 30, 1997, and before August 1, 1999.

D. Orphan Drug Tax Credit (sec. 504 of the bill and sec. 45C of the Code)

Present Law

A 50-percent nonrefundable tax credit is allowed for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." Qualified testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration ("FDA") but before the drug has been approved for sale by the FDA. A rare disease or condition is defined as one that (1) affects less than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from U.S. sales of the drug. These rare diseases and conditions include Huntington's disease, myoclonus, ALS (Lou Gehrig's disease), Tourette's syndrome, and Duchenne's dystrophy (a form of muscular dystrophy).

As with other general business credits (sec. 38), taxpayers are allowed to carry back unused credits to three years preceding the year the credit is earned (but not to a taxable year ending before July 1, 1996) and to carry forward unused credits to 15 years following the year the credit is earned. The credit cannot be used to offset a taxpayer's alternative minimum tax liability.

The orphan drug tax credit expired and does not apply to expenses paid or incurred after May 31, 1997.[40]

Reasons for Change

In order to encourage the socially optimal level of research to develop drugs to treat rare diseases and conditions—and because the research and clinical testing of such drugs often must be conducted over several years—the Committee believes that the orphan drug tax credit should be permanently extended.

Explanation of Provision

The orphan drug tax credit provided for by section 45C is permanently extended.

Effective Date

The provision is effective for qualified clinical testing expenses paid or incurred after May 31, 1997.

[40] The orphan drug tax credit originally was enacted in 1983 and was extended on several occasions. The credit expired on December 31, 1994, and later was reinstated for the period July 1, 1996, through May 31, 1997.

TITLE VI. DISTRICT OF COLUMBIA TAX INCENTIVES (secs. 601 and 602 of the bill and new secs. 1400–1400B of the Code)

Present Law

Empowerment zones and enterprise communities

In general

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas (with aggregate population for the six designated urban empowerment zones limited to 750,000) and three empowerment zones are located in rural areas.[41] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations (sec. 1392). Portions of the District of Columbia were designated as an enterprise community.

The following tax incentives are available for certain businesses located in empowerment zones: (1) an annual 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of expensing under Code section 179 for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to $38,000 of expensing for 1997; the allowable amount will increase to $38,500 for 1998); and (3) special tax-exempt financing for certain zone facilities.

The 95 enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period.

Definition of "qualified zone property"

Present-law section 1397C defines "qualified zone property" as depreciable tangible property (including buildings), provided that: (1) the property is acquired by the taxpayer (from an unrelated party) after the zone or community designation took effect; (2) the original use of the property in the zone or community commences with the taxpayer; and (3) substantially all of the use of the property is in the zone or community in the active conduct of a trade

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

or business by the taxpayer in the zone or community. In the case of property which is substantially renovated by the taxpayer, however, the property need not be acquired by the taxpayer after zone or community designation or originally used by the taxpayer within the zone or community if, during any 24-month period after zone or community designation, the additions to the taxpayer's basis in the property exceed the greater of 100 percent of the taxpayer's basis in the property at the beginning of the period, or $5,000.

Definition of "enterprise zone business"

Present-law section 1397B defines the term "enterprise zone business" as a corporation or partnership (or proprietorship) if for the taxable year: (1) the sole trade or business of the corporation or partnership is the active conduct of a qualified business within an empowerment zone or enterprise community; (2) at least 80 percent of the total gross income is derived from the active conduct of a "qualified business" within a zone or community; (3) substantially all of the business's tangible property is used within a zone or community; (4) substantially all of the business's intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within a zone or community; (6) at least 35 percent of the employees are residents of the zone or community; and (7) no more than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.

A "qualified business" is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.[42] In addition, the leasing of real property that is located within the empowerment zone or community to others is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property to others is not a qualified business unless substantially all of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone or enterprise community.

Taxation of capital gains

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain generally is taxed at the same rate as ordinary income, except that the maximum rate of tax is limited to 28 percent of the net capital gain.[43] Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital

[42] Also, a qualified business does not include certain facilities described in section 144(c)(6)(B) (e.g., massage parlor, hot tub facility, or liquor store) or certain large farms.

[43] The Revenue Reconciliation Act of 1993 added Code section 1202, which provides a 50-percent exclusion for gain from the sale of certain small business stock acquired at original issue and held for at least five years.

loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, and (5) certain publications of the Federal Government.

In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property generally is not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method.

Reasons for Change

The Committee believes that the District of Columbia faces two key problems—inability to attract and retain a stable residential base and insufficient economic activity. To this end, the Committee has provided certain tax incentives to attract new homeowners to the District and to encourage economic development in those areas of the District where development has been inadequate. However, the Committee is aware that the efficacy of tax incentives to address one or both problems is severely limited absent fundamental structural reform of the District's government and economy. Thus, the availability of the tax incentives is contingent on the passage of other Federal legislation that will implement such critical structural reforms.

Explanation of Provision

The following tax incentives take effect only if, prior to January 1, 1998, a Federal law is enacted creating a District of Columbia economic development corporation that is an instrumentality of the District of Columbia government.

First-time homebuyer credit

The bill provides first-time homebuyers of a principal residence in the District a tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit amount applies both to individuals and married couples. Married individuals filing separately can claim a maximum credit of $2,500 each. The Secretary of Treasury is directed to prescribe regulations allocating the credit among unmarried purchasers of a residence.[44]

To qualify as a "first-time homebuyer," neither the individual (nor the individual's spouse, if married) can have had a present ownership interest in a principal residence in the District for the one-year period prior to the date of acquisition of the principal residence.[45]

A taxpayer will be treated as a first-time homebuyer with respect to only one residence—i.e., the credit may be claimed one time only. The date of acquisition is the date on which a binding contract to purchase the principal residence is entered into or the date on which construction or reconstruction of such residence commences.

The credit applies to purchases after the date of enactment and before January 1, 2002. Any excess credit may be carried forward indefinitely to succeeding taxable years.

Tax credits for equity investments in and loans to businesses located in the District of Columbia

A newly created economic development corporation is authorized to allocate $75 million in tax credits to taxpayers that make certain equity investments in, or loans to, businesses (either corporations or partnerships) engaged in an active trade or business in the District of Columbia. Factors to be considered in the allocation of credits include whether the project would provide job opportunities for low and moderate income residents of, and whether the business is located in, certain targeted areas. These areas are (1) all census tracts that presently are part of the D.C. enterprise community designated under section 1391 (i.e., portions of Anacostia, Mt. Pleasant, Chinatown, and the easternmost part of the District) and (2) all additional census tracts within the District of Columbia where the poverty rate is at least 35 percent. Eligible businesses are not be required to satisfy the criteria of a qualified D.C. business, described below. Such credits are nonrefundable and can be used to offset a taxpayer's alternative minimum tax (AMT) liability.

Under the bill, the amount of credit cannot exceed 25 percent of the amount invested (or loaned) by the taxpayer. Thus, the economic development corporation is permitted to allocate the full $75 million in tax credits to no less than $300 million in equity investments in, or loans, to eligible businesses.

Under the bill, credits may be allocated to loans made to an eligible business only if the business uses the loan proceeds to purchase depreciable tangible property and any functionally related and subordinate land. Credits may be allocated to equity investments only if the equity interest was acquired for cash. Any credits allocated to a taxpayer making an equity investment are subject to recapture

[44] The provision of the bill that excludes sales of certain personal residences from the real estate transaction reporting requirement would not apply to sales of personal residences in the District of Columbia. In addition, the Committee anticipates that the Secretary of Treasury will require such information as may be necessary to verify eligibility for the D.C. first-time homebuyer credit.

[45] Special rules apply to members of the Armed Forces and certain individuals with tax homes outside the United States with respect to whom the rollover period available under section 1034 (as in effect prior to the enactment of the bill) is suspended pursuant to sections 1034(h) or (k).

if the equity interest is disposed of by the taxpayer within five years. A taxpayer's basis in an equity investment is reduced by the amount of the credit.

The bill applies to credit amounts allocated for taxable years beginning after December 31, 1997, and before January 1, 2003.[46]

Zero-percent capital gains rate

The bill provides a zero-percent capital gains rate for capital gains from the sale of certain qualified D.C. assets held for more than five years. In general, qualified D.C. assets mean stock or partnership interests held in, or tangible property held by, a qualified D.C. business.

Qualified D.C. business

A "qualified D.C. business" generally is required to satisfy the requirements of an "enterprise zone business" under present law, applied as if the District (in its entirety) were an empowerment zone. Thus, a corporation or partnership is a qualified D.C. business if (1) its sole trade or business is the active conduct of a "qualified business" within the District; (2) at least 80 percent of the total gross income is derived from the active conduct of a "qualified business" within the District; (3) substantially all of the business's tangible property is used within the District; (4) substantially all of the business's intangible property is used in, and exclusively related to, the active conduct of such business; (5) substantially all of the services performed by employees are performed within the District; and (6) no more than five percent of the average of the aggregate unadjusted bases of the property owned by the business is attributable to (a) certain financial property, or (b) collectibles not held primarily for sale to customers in the ordinary course of an active trade or business.[47] A "qualified business" means any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license.[48] In addition, the leasing of real property that is located within the District to others is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from qualified D.C. businesses. The rental of tangible personal property to others is not be a qualified business unless substantially all of the rental of such property is by qualified D.C. businesses or by residents of the District.

Qualified D.C. assets

For purposes of the bill, "qualified D.C. assets" include (1) D.C. business stock, (2) D.C. partnership interests, and (3) D.C. business property.

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[46] As a general business credit, the credit can be carried back three years (but not before January 1, 1998) and forward for fifteen years.

[47] The requirement under present-law section 1397B(b)(6) that at least 35 percent of the employees of the business be zone residents does not apply when determining whether an entity is a qualified D.C. business.

[48] Also, as under present law, a qualified business does not include certain facilities described in section 144(c)(6)(B) (e.g., massage parlor, hot tub facility, or liquor store) or certain large farms.

"D.C. business stock" means stock in a domestic corporation originally issued after December 31, 1997, that, at the time of issuance[49] and during substantially all of the taxpayer's holding period, was a qualified D.C. business, provided that such stock was acquired by the taxpayer on original issue from the corporation solely in exchange for cash before January 1, 2003.[50] A "D.C. partnership interest" means a domestic partnership interest originally issued after December 31, 1997, that is acquired by the taxpayer from the partnership solely in exchange for cash before January 1, 2003, provided that, at the time such interest was acquired[51] and during substantially all of the taxpayer's holding period, the partnership was a qualified D.C. business. Finally, "D.C. business property" means tangible property acquired by the taxpayer by purchase (within the meaning of present law section 179(d)(2)) after December 31, 1997, and before January 1, 2003, provided that the original use of such property in the District commences with the taxpayer and substantially all of the use of such property during substantially all of the taxpayer's holding period was in a qualified D.C. business of the taxpayer.

A special rule provides that, in the case of business property that is "substantially renovated," such property need not be acquired by the taxpayer after December 31, 1997, nor need the original use of such property in the District commence with the taxpayer. For these purposes, property is treated as "substantially renovated" if, prior to January 1, 2003, additions to basis with respect to such property in the hands of the taxpayer during any 24-month period beginning after December 31, 1997, exceed the greater of (1) an amount equal to the adjusted basis at the beginning of such 24-month period in the hands of the taxpayer, or (2) $5,000. Thus, substantially renovated real estate located in the District can constitute D.C. business property. However, the bill specifically excludes land that is not an integral part of a D.C. business from the definition of D.C. business property.

In addition, qualified D.C. assets include property that was a qualified D.C. asset in the hands of a prior owner, provided that at the time of acquisition, and during substantially all of the subsequent purchaser's holding period, either (1) substantially all of the use of the property is in a qualified D.C. business, or (2) the property is an ownership interest in a qualified D.C. business.

In general, gain eligible for the zero-percent tax rate means gain from the sale or exchange of a qualified D.C. asset that is (1) a capital asset or (2) property used in the trade or business as defined in section 1231(b). Gain attributable to periods before December 31, 1997, is not qualified capital gain. No gain attributable to real property, or an intangible asset, which is not an integral part of a D.C. business qualifies for the zero-percent rate.

[49] In the case of a new corporation, it is sufficient if the corporation is being organized for purposes of being a qualified D.C. business.

[50] As under section 1202(c)(3), qualified D.C. business stock does not include any stock acquired from a corporation which made a substantial stock redemption or distribution (without a bona fide business purpose therefore) in an attempt to avoid the purposes of the provision. A similar rule applies with respect to qualified D.C. partnership interests.

[51] In the case of a new partnership, it is sufficient if the partnership is being formed for purposes of being a D.C. business.

The bill provides that property that ceases to be a qualified D.C. asset because the property is no longer used in (or no longer represents an ownership interest in) a qualified D.C. business after the five-year period beginning on the date the taxpayer acquired such property continues to be treated as a qualified D.C. asset. Under this rule, the amount of gain eligible for the zero-percent capital gains rate cannot exceed the amount which would be qualified capital gain had the property been sold on the date of such cessation.

Special rules are provided for pass-through entities (i.e., partnerships, S corporations, regulated investment companies, and common trust funds). In the case of a sale or exchange of an interest in a pass-through entity that was not a qualified D.C. business during substantially all of the period that the taxpayer held the interest, the zero-percent capital gains rate applies to the extent that the gain is attributable to amounts that would have been qualified capital gain had the underlying assets been sold for their fair market value on the date of the sale or exchange of the interest in the pass-through entity. This rule applies only if the interest in the pass-through entity were held by the taxpayer for more than five years. In addition, the rule applies apply only to qualified D.C. assets that were held by the pass-through entity for more than five years, and throughout the period that the taxpayer held the interest in the pass-through entity.

The bill also provides that, in the case of a transfer of a qualified D.C. asset by gift, at death, or from a partnership to a partner that held an interest in the partnership at the time that the qualified D.C. asset was acquired, (1) the transferee is to be treated as having acquired the asset in the same manner as the transferor, and (2) the transferee's holding period includes that of the transferor. In addition, rules similar to those contained in section 1202(i)(2) regarding treatment of contributions to capital after the original issuance date and section 1202(j) regarding treatment of certain short positions apply.

Effective Date

The D.C. first-time homebuyer credit is effective for purchases after the date of enactment and before January 1, 2002. The tax credit for equity investments and loans applies to credit amounts allocated for taxable years beginning after December 31, 1997, and before January 1, 2003. The zero-percent tax rate for capital gains is effective for qualified D.C. assets purchased (or substantially renovated) during the period January 1, 1998, through December 31, 2002, for any gain accruing with respect to such assets after the date or purchase (or substantial renovation).

TITLE VII. MISCELLANEOUS PROVISIONS

A. Excise Tax Provisions

1. Repeal excise tax on diesel fuel used in recreational motorboats (sec. 901 of the bill and secs. 4041 and 6427 of the Code)

Present Law

Before a temporary suspension through December 31, 1997 was enacted in 1996, diesel fuel used in recreational motorboats was subject to the 24.3-cents-per-gallon diesel fuel excise tax. Revenues from this tax were retained in the General Fund. The tax was enacted by the Omnibus Budget Reconciliation Act of 1993 as a revenue offset for repeal of the excise tax on certain luxury boats.

Reasons for Change

Many marinas have found it uneconomical to carry both undyed (taxed) and dyed (untaxed) diesel fuel because the majority of their market is for uses not subject to tax. As a result, some recreational boaters have experienced difficulty finding fuels. In 1996, Congress suspended imposition of the tax on recreational boating while alternative collection methods were evaluated. No satisfactory alternative has been found; therefore, the Committee determined that competing needs for boat fuel availability and preservation of the integrity of the diesel fuel tax compliance structure are best served by repealing the diesel fuel tax on recreational motorboat use.

Explanation of Provision

The bill repeals the application of the diesel fuel tax to fuel used in recreational motorboats.

Effective Date

The provision is effective for fuel sold after December 31, 1997.

2. Create Intercity Passenger Rail Fund (sec. 702 of the bill and new sec. 9901 of the Code)

Present Law

Separate Federal excise taxes are imposed on specified transportation motor fuels. Taxable fuels include gasoline, diesel fuel, and special motor fuels used for highway transportation, gasoline and diesel fuel used in motorboats, diesel fuel used in trains, fuels used in inland waterway transportation, and aviation fuel (gasoline and jet fuel). Motor fuels used by all of these transportation sectors are subject to a permanent 4.3-cents-per-gallon excise tax, enacted by the Omnibus Budget Reconciliation Act of 1993. Revenues from the 4.3-cents-per-gallon excise tax are retained in the General Fund of the Treasury.

The aggregate tax rate varies for each transportation sector. For example, diesel fuel used in trains is subject to an aggregate General Fund tax rate of 5.55 cents per gallon. Transportation sectors that benefit from Federal public works and environmental programs also are subject to additional tax rates (beyond the 4.3-cents-per-gallon General Fund rate) to finance Federal Trust Funds established as a financing source for those programs. All motor fuels excise taxes other than the 4.3-cents-per-gallon General Fund excise tax are temporary (i.e., have scheduled expiration dates). Table 1, below, shows the tax rates applicable to various transportation sectors, by Trust Fund and General Fund component.

Table 1.—Present-Law Federal Motor Fuels Excise Tax Rates on Various Transportation Sectors

[Rates shown in cents per gallon]

Transportation sector	Trust fund	General fund	Total tax
Highway Transportation:			
In general (trucks, automobiles):			
Gasoline	14.0	4.3	18.3
Diesel fuel	20.0	4.3	24.3
Special motor fuels	14.0	4.3	18.3
Private intercity bus:			
Gasoline	(*)	(*)	(*)
Diesel fuel	3.0	4.3	7.3
Rail Transportation	(*)	5.55	5.55
Water Transportation:			
Inland waterway	20.0	4.3	24.3
Recreational boats:			
Gasoline	14.0	4.3	18.3
Diesel fuel	(*)	[52](*)	(*)
Air Transportation:			
Commercial aviation	(*)	4.3	4.3
Noncommercial aviation:			
Gasoline	15.0	4.3	19.3
Jet fuel	17.5	4.3	21.8

* No tax.

Reasons for Change

The Committee believes that the provision of viable intercity passenger rail service is an important national objective. At present, that objective is threatened by capital needs of the principal passenger rail service provider. Accordingly, the bill provides for transfer of a portion of transportation motor fuels tax revenues to promote needed modernization of passenger rail service facilities.

[52] A General Fund tax rate of 24.3 cents per gallon, enacted in 1993 to be effective through December 31, 1999, was suspended through December 31, 1997, by the Small Business Job Protection Tax Act of 1996. Another proposal in the Chairman's Mark would repeal this tax on diesel fuel used in recreational motorboats.

Explanation of Provision

Intercity Rail Fund provisions

The bill establishes an Intercity Passenger Rail Fund (the "Rail Fund") in the Internal Revenue Code. The Rail Fund will be financed with amounts equivalent to 0.5 cent per gallon of the excise taxes imposed on *all* gasoline, diesel fuel, special motor fuels, inland waterway fuels, and aviation fuels after September 30, 1997, and before April 16, 2001.

Amounts deposited in the Rail Fund are divided between Amtrak and States not receiving Amtrak passenger rail service to finance obligations incurred after September 30, 1997, and before April 16, 2001. Although transfers to the Rail Fund and authority to enter into new obligations would terminate after April 15, 2001, monies deposited in the Fund will remain available to satisfy outstanding obligations.

Each State not receiving Amtrak rail service will receive an allocation each fiscal year not exceeding one percent of the lesser of (1) Rail Fund revenues for the year or (2) the aggregate amount appropriated from the Rail Fund for the year. Allocations to these non-Amtrak States will be pro-rated on a monthly basis if Amtrak service is provided in the State during a portion of a fiscal year. Non-Amtrak States may use the amounts they receive for capital improvements and maintenance expenditures related to intercity passenger rail and bus service provided within their respective jurisdictions (including purchase of intercity passenger rail services from Amtrak) and certified by the Department of Transportation as eligible. The balance of the Rail Fund revenues are available, as certified by the Department of Transportation, to Amtrak for financing capital improvements, including equipment, rolling stock, and maintenance facilities, as well as for maintenance of existing equipment.

Pursuant to section 207 of H. Con. Res. 84, of the total revenues raised in the bill, the amounts equal to the amounts deposited in the Intercity Passenger Rail Fund each year, are dedicated to finance that Fund.

Tax treatment of Rail Fund expenditures

Amounts received from the Rail Fund by Amtrak and other taxable entities are not included in gross income when received. However, the basis of any property financed with the monies will be reduced by the tax-free amounts received, and no deduction will be allowed for any expenditures attributable to those amounts.

Effective Date

The provision is effective on October 1, 1997.

3. Provide a lower rate of alcohol excise tax on certain hard ciders (sec. 703 and sec. 5041 of the Code)

Present Law

Distilled spirits are taxed at a rate of $13.50 per proof gallon; beer is taxed at a rate of $18 per barrel (approximately 58 cents per gallon); and still wines of 14 percent alcohol or less are taxed at a rate of $1.07 per wine gallon. Higher rates of tax are applied to wines with greater alcohol content and sparkling wines.

Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of wine produced annually. Certain small breweries pay a reduced tax of $7.00 per barrel (approximately 22.6 cents per gallon) on the first 60,000 barrels of beer produced annually.

Apple cider containing alcohol ("hard cider") is classified and taxed as wine.

Reasons for Change

The Committee understands that as an alcoholic beverage, hard cider competes more as a substitute for beer than as a substitute for table wine. If most consumers of alcoholic beverages choose between hard cider and beer, rather than between hard cider and wine, taxing hard cider at tax rates imposed on other wine products may distort consumer choice and unfairly disadvantage producers of hard cider in the market place. The Committee also understands that producers of hard cider generally are small businesses and has concluded that it would improve market efficiency and fairness to tax this beverage at a rate equivalent to the tax imposed on the production of beer by small brewers.

Explanation of Provision

The bill adjusts the tax rate on apple cider having an alcohol content of no more than seven percent to 22.6 cents per gallon for those persons who produce more than 100,000 gallons of apple cider during a calendar year. The tax rate applicable to apple cider produced by persons who produce 100,000 gallons or less in a calendar year will remain as under present law and those persons may continue to claim the credit permitted for small wineries. Apple cider production will continue to be counted in determining whether other production of a producer qualifies for the tax credit for small producers. The bill does not change the classification of qualifying apple cider as wine.

Effective Date

The provision is effective for hard cider removed after September 30, 1997.

4. Transfer of General Fund highway fuels tax to the Highway Trust Fund (sec. 704 of the bill and sec. 9503 of the Code)

Present Law

Federal excise taxes are imposed on highway motor fuels to finance the Highway Trust Fund (currently, through September 30, 1999): 14 cents per gallon on highway gasoline and special motor fuels, 20 cents per gallon on highway diesel fuel, and 3 cents per gallon on diesel fuel used by intercity buses. Buses pay no Federal gasoline tax. Reduced tax rates apply to ethanol and methanol fuels. In addition, a permanent General Fund tax of 4.3 cents per gallon applies to highway and other motor fuels (other than intercity bus gasoline and recreational motorboat diesel fuels, which are not subject to the tax, and rail diesel fuel, which pays a General Fund tax of 5.55 cents per gallon).

Amounts equivalent to 2 cents per gallon of the Highway Trust Fund motor fuels tax revenues are credited to the Mass Transit Account of the Trust Fund for capital-related expenditures on mass transit programs; the balance of the highway motor fuels tax revenues are credited to the Highway Account of the Trust Fund for highway-related programs generally.

Transfers are made from the Highway Trust Fund of up to $70 million per fiscal year (through September 30, 1997) to the Boat Safety Account of the Aquatic Resources Trust Fund of amounts equivalent to 11.5 cents per gallon from recreational motorboat gasoline and special motor fuels revenues, plus up to $1 million per fiscal year to the Land and Water Conservation Fund. Any excess revenues attributable to the tax on motorboat fuels is to be transferred from the Highway Trust Fund to the Sport Fish Restoration Account in the Aquatic Resources Trust Fund.

Reasons for Change

The Committee determined that the balance of the existing General Fund excise tax on highway fuels, after the transfer of 0.5 cent per gallon to the new Intercity Passenger Rail Fund established under section 702 of this bill, should be transferred to the Highway Trust Fund to ensure that more funds will be available for needed Highway Trust Fund programs in the future. It is widely suggested by transportation officials and users that there is an urgent need for improved and enhanced highway and transit systems in the nation to meet the needs of a growing transportation system.

Explanation of Provision

The bill transfers the existing General Fund excise tax of 4.3 cents per gallon on motor fuels used in highway transportation to the Highway Trust Fund, beginning on October 1, 1997, except for the temporary transfer of the 0.5 cent per gallon that will go to the Intercity Passenger Rail Fund under section 702 of the bill for the period October 1, 1997 through April 15, 2001. Of the amounts transferred to the Highway Trust fund (3.8 cents or 4.3 cents), 20 percent is to go to the Mass Transit Account and 80 percent to the Highway Account.

The increased deposits to the Highway Trust Fund may not be used to cause an increase in the allocations under section 157 of Title 23 of the U.S. Code or any other increase beyond in direct spending other than by enactment of future legislation in compliance with the Budget Enforcement Act.

Effective Date

The provision is effective on October 1, 1997.

5. Tax certain alternative fuels based on energy equivalency to gasoline (sec. 705 of the bill and sec. 4041 of the Code)

Present Law

Excise taxes are imposed on gasoline, diesel fuel, and special motor fuels used in highway vehicles. 4.3 cents per gallon of each of these taxes is retained in the General Fund, with the balance of the revenues being dedicated to one or more Trust Funds. The tax on gasoline is 18.3 cents per gallon; the tax on diesel fuel is 24.3 cents per gallon; and the tax on special motor fuels generally is 18.3 cents per gallon. Taxable special motor fuels include liquefied petroleum gas ("propane"), liquefied natural gas ("LNG"), methanol from natural gas, and compressed natural gas ("CNG"). Special rates apply to methanol from natural gas (exempt from 7 cents of the 14-cents-per-gallon Highway Trust Fund component of the special motor fuels tax), and compressed natural gas (exempt from the entire Highway Trust Fund component of the tax).

In general, these four special motor fuels contain less energy (i.e., fewer Btu's) per gallon than does gasoline.

Reasons for Change

The largest portion of the excise tax on propane, LNG, and methanol from natural gas is imposed to finance Federal highway programs through the Highway Trust Fund. A basic principle of the highway taxes is that users of the highway system should be taxed in relation to their use of the system. Adjusting the tax rates on these three special motor fuels is consistent with that principle because consumers must purchase more gallons of these lower-energy-content fuels than gallons of gasoline to travel the same number of miles.

Explanation of Provision

The tax rates on propane, LNG, and methanol from natural gas are adjusted to reflect the respective energy equivalence of the fuels to gasoline. The revised tax rates on these fuels are: propane, 13.6 cents per gallon; LNG 11.9 cents per gallon, and methanol from natural gas, 9.15 cents per gallon.

Effective Date

The provision is effective for fuels sold or used after September 30, 1997.

6. Study feasibility of moving collection point for distilled spirits excise tax (sec. 706 of the bill)

Present Law

Distilled spirits are subject to tax at $13.50 per proof gallon. (A proof gallon is a liquid gallon consisting of 50 percent alcohol.) In the case of domestically produced distilled spirits and distilled spirits imported in to the United States in bulk containers for domestic bottling, the tax is imposed on removal of the beverage from the distillery (without regard to whether a sale occurs at that time).

Bottled distilled spirits that are imported into the United States comprise approximately 15 percent of the current market for these beverages; tax is imposed on these imports when the distilled spirits are removed from the first customs bonded warehouse in which they are deposited upon entry into the United States.

In the case of certain distilled spirits products, a tax credit for alcohol derived from fruit is allowed. This credit reduces the effective tax paid on those beverages. The credit is determined when the tax is paid (i.e., at the distillery or on importation).

Explanation of Provision

The Treasury Department is directed to study options for changing the point at which the distilled spirits excise tax is collected. One of the options evaluated should be collecting the tax at the point at which the distilled spirits are removed from registered wholesale warehouses. As part of this study, the Treasury is to focus on administrative issues associated with the identified options, including the effects on tax compliance. For example, the Treasury is to evaluate the actual compliance record of wholesale dealers that currently paid the excise tax on imported bottled distilled spirits, and the compliance effects of allowing additional wholesale dealers to be distilled spirts taxpayers. The study also is to address the number of taxpayers involved, the types of financial responsibility requirements that might be needed, any special requirements regarding segregation of non-tax-paid distilled spirits from other products carried by the potential new taxpayers. The study further is to review the effects of the options on Treasury staffing and other budgetary resources as well as projections of the time between when tax currently is collected and the time when tax otherwise would be collected.

The study is required to be completed and transmitted to the Committee on Finance and the Committee on Ways and Means no later than January 31, 1998.

7. Extend and modify tax benefits for ethanol (sec. 707 of the bill and secs. 40, 4041, 4081, 4091, and 6427 of the Code)

Present Law

Present law provides a 54-cents-per-gallon income tax credit for ethanol and a 60-cents-per-gallon income tax credit for methanol produced from renewable sources (e.g., biomass) that are used as a motor fuel or that are blended with other fuels (e.g., gasoline) for such a use. As an alternative to claiming the income tax credits directly, these tax benefits may be claimed as a reduction in the amount of excise tax paid on gasoline or diesel fuel with which the ethanol or renewable source methanol are blended or as a reduction in the special motor fuels rate applicable to "neat" ethanol or renewable source methanol fuels. The excise tax delivery of the benefits occurs either through reduced tax rate sales to registered blenders of e.g., gasoline or diesel fuel, or through expedited refunds of gasoline or diesel fuel tax paid.

In addition to these general ethanol benefits, a separate 10-cents-per-gallon credit is provided for small ethanol producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. No comparable small producer credit is provided for small renewable source methanol producers.

Treasury Department regulations provide that ethyl tertiary butyl ether ("ETBE"), which is made using ethanol, qualifies for the blender income tax credit and the excise tax exemption.

The alcohol fuels tax benefits are scheduled to expire after December 31, 2000. The provision allowing the ethanol blender benefits to be claimed through the motor fuels excise tax system is scheduled to expire after September 30, 2000.

Reasons for Change

The Committee believes that continued assurance of tax benefits for ethanol are an important signal to encourage the use of alternative fuels.

Explanation of Provision

The bill extends the 54-cents-per-gallon income tax credit for ethanol through December 31, 2007, and the excise tax provisions allowing that benefit to be claimed through reduced-tax-rate gasoline sales (or expedited refunds of gasoline tax paid) through September 30, 2007. In addition, the bill phases down the rates of the benefits during the period 2001 through 2007. Under the bill, the tax benefit per gallon of ethanol will be: 2001 and 2002—53 cents per gallon, 2003 and 2004—52 cents per gallon, 2005, 2006, and 2007—51 cents per gallon.

Effective Date

The provision is effective on the date of enactment.

8. Codify Treasury Department regulations regulating wine labels (sec. 708 of the bill and sec. 5388 of the Code)

Present Law

The Code includes provisions regulating the labeling of wine when it is removed from a winery for marketing. In general, the regulations under these provisions allow the use of semi-generic names for wine that reflect geographic identifications understood in the industry, provided that the labels include clear indication of any deviation from that which is generally understood in the source of the grapes or the process by which the wine is produced.

Reasons for Change

The Committee determined that the Treasury Department regulations governing the use of semi-generic designations such as "Chablis" and "burgundy" in wine labeling should be codified to add clarity to the existing Code provisions.

Explanation of Provision

The current Treasury Department regulations governing the use of semi-generic wine designations which reflect geographic origin are codified into the Code's wine labeling provisions.

Effective Date

The provision is effective on the date of enactment.

B. Provisions Relating to Pensions

1. Treatment of multiemployer plans under section 415 (sec. 711 of the bill and sec. 415(b) of the Code)

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan. In the case of defined benefit pension plans, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) $125,000 (indexed for inflation).

Reasons for Change

The limits on contributions and benefits create unique problems for multiemployer defined benefit pension plans.

Explanation of Provision

The bill eliminates the application of the 100 percent of compensation limitation for multiemployer defined benefit pension plans. Such plans will only be subject to the dollar limitation.

Effective Date

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

2. Modification of partial termination rules (sec. 712 of the bill and sec. 552 of the Deficit Reduction Act of 1984)

Present Law

Under the Internal Revenue Code, pension plan benefits are required to become fully vested upon termination or partial termination of the plan. The plan document is required to contain a provision reflecting this rule. Under section 552 of the Deficit Reduction Act of 1984 ("DEFRA"), for purposes of this rule, a partial termination is treated as not occurring if (1) the partial termination is a result of a decline in plan participation which occurs by reason of the completion of the Trans-Alaska Oil Pipeline construction project and occurred after December 31, 1975, and before January 1, 1980, with respect to participants employed in Alaska; (2) no discrimination occurred with respect to the partial termination; and (3) it is established to the satisfaction of the Secretary of the Treasury that the benefits of the provision will not accrue to the employers under the plan.

Reasons for Change

The Committee is concerned that section 552 of DEFRA has not operated as intended because of a conflict between section 552 and the requirement that a plan document provide that plan benefits become nonforfeitable upon a full or partial plan termination. The

Committee bill eliminates this conflict by clarifying that section 552 of DEFRA applies notwithstanding any other provision of law or of the plan or trust.

Explanation of Provision

The bill clarifies that section 552 of DEFRA applies for the Code, any other provision of law, and any plan or trust provision.

Effective Date

The provision is effective as if included in section 552 of DEFRA.

3. Increase in full funding limit (sec. 713 of the bill and sec. 412 of the Code)

Present Law

Under present law, defined benefit pension plans are subject to minimum funding requirements. In addition, there is a maximum limit on contributions that can be made to a plan, called the full funding limit. The full funding limit is the lesser of a plan's accrued liability and 150 percent of current liability. In general, current liability is all liabilities to plan participants and beneficiaries. Current liability represents benefits accrued to date, whereas the accrued liability full funding limit is based on projected benefits.

Reasons for Change

The 150-percent of full funding limit was enacted to limit and allocate efficiently the Federal tax revenue associated with the special tax treatment provided to tax-qualified plans. However, the Committee believes that the 150-percent of current liability full funding limit unduly restricts funding.

Explanation of Provision

The bill increases the 150-percent of full funding limit as follows: 155 percent for plan years beginning in 1999 or 2000, 160 percent for plan years beginning in 2001 or 2002, 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.

Effective Date

The provision is effective for plan years beginning after December 31, 1998.

4. Spousal consent required for distributions from section 401(k) plans (sec. 714 of the bill and secs. 411 and 417 of the Code)

Present Law

Under present law, pension plans that provide automatic survivor benefits (i.e., joint and survivor annuities and preretirement survivor annuities) require spousal consent to the payment of a participant's benefit in a form other than a survivor annuity. A qualified cash or deferred arrangement (a "section 401(k) plan") is not subject to the automatic survivor benefit rules if the plan provides that the spouse of a participant is the beneficiary of the participant's entire account under the plan, the participant's benefit is not paid in the form or an annuity, and the participant's account does not include amounts transferred from another plan that was subject to the automatic survivor benefit rules. In general, spousal consent is not required for an involuntary cash-out of a participant's benefit or distributions made to satisfy the minimum distribution rules.

Reasons for Change

The Committee believes that spouses of participants in 401(k) plans who are entitled to benefits under the plan should be afforded similar protection as spouses in pension plans that provide automatic survivor benefits.

Explanation of Provision

The bill provides that written spousal consent is required for all distributions, including plan loans, from plans containing a qualified cash or deferred arrangement. As under present law, spousal consent is not required for an involuntary cash-out of a participant's benefit or for the payment of distributions required under the minimum distribution rules. If spousal consent is not obtained, the benefit must be distributed in equal periodic payments over the life (or life expectancy) of the participant, the lives (or life expectancies) of the participant and beneficiary, or over a period of 10 years or more. A plan which complies with the spousal consent requirement will not be treated as failing to satisfy the anti-cutback rules related to optional forms of benefit. The bill also will make the corresponding changes to the Employment Income Security Act of 1974, as amended ("ERISA").

Effective Date

The provision is effective for plan years beginning after December 31, 1998.

5. Contributions on behalf of a minister to a church plan (sec. 715 of the bill and sec. 414(e) of the Code)

Present Law

Under present law, contributions made to retirement plans by ministers who are self-employed are deductible to the extent such contributions do no exceed certain limitations applicable to retirement plans. These limitations include the limit on elective deferrals, the exclusion allowance, and the limit on annual additions to a retirement plan.

Reasons for Change

The Committee believes that the unique characteristics of church plans and the procedures associated with contributions made by ministers who are self-employed create particular problems with respect to plan administration.

Explanation of Provision

The bill provides that in the case of a contribution made on behalf of a minister who is self-employed to a church plan, the contribution will be excludable from the income of the minister to the extent that the contribution would be excludable if the minister was an employee of a church and the contribution was made to the plan.

Effective Date

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

6. Exclusion of ministers from discrimination testing of certain non-church retirement plans (sec. 715 of the bill and sec. 414(e) of the Code)

Present Law

Under present law ministers who are employed by an organization other than a church are treated as if employed by the church and may participate in the retirement plan sponsored by the church. If the organization also sponsors a retirement plan, such plan does not have to include the ministers as employees for purposes of satisfying the nondiscrimination rules applicable to qualified plans provided the organization is not eligible to participate in the church plan.

Reasons for Change

The Committee believes it is appropriate to extend the same relief to other non-church organizations that may be eligible to participate in a church plan but elect not to do so. Such organizations will not be required to treat ministers as employees for purposes of satisfying the nondiscrimination rules applicable to their retirement plan.

Explanation of Provision

The bill provides that if a minister is employed by an organization other than a church and the organization is not otherwise participating in the church plan then, the minister does not have to be included as an employee under the retirement plan of the organization for purposes of the nondiscrimination rules.

Effective Date

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

7. Repeal application of UBIT to ESOPs of S corporations (sec. 716 of the bill and sec. 512 of the Code)

Present Law

Under present law, for taxable years beginning after December 31, 1997, certain tax-exempt organizations, including employee stock ownership plans ("ESOPs") can be a shareholder of an S corporation. Items of income or loss of the S corporation will flow through to qualified tax-exempt shareholders as unrelated business taxable income ("UBTI"), regardless of the source of the income.

Reasons for Change

The Committee believes that treating S corporation income as UBTI is not appropriate because such amounts would be subject to tax at the ESOP level, and also again when benefits are distributed to ESOP participants.

Explanation of Provision

The bill repeals the provision treating items of income or loss of an S corporation as unrelated business taxable income in the case of an employee stock ownership plan that is an S corporation shareholder.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

C. Provisions Relating to Disasters

1. Treatment of livestock sold on account of weather-related conditions (sec. 721 of the bill and secs. 451 and 1033 of the Code)

Present Law

In general, cash-method taxpayers report income in the year it is actually or constructively received. However, present law contains two special rules applicable to livestock sold on account of drought conditions. Code section 451(e) provides that a cash-method taxpayer whose principal trade or business is farming who is forced to sell livestock due to drought conditions may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for drought conditions that resulted in the area being designated as eligible for Federal assistance. This exception is generally intended to put taxpayers who receive an unusually high amount of income in one year in the position they would have been in absent the drought.

In addition, the sale of livestock (other than poultry) that is held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought conditions is treated as an involuntary conversion under section 1033(e). Consequently, gain from the sale of such livestock could be deferred by reinvesting the proceeds of the sale in similar property within a two-year period.

Reasons for Change

The Committee believes that the present-law exceptions to gain recognition for livestock sold on account of drought should apply to livestock sold on account of floods and other weather-related conditions as well.

Explanation of Provision

The bill amends Code section 451(e) to provide that a cash-method taxpayer whose principal trade or business is farming and who is forced to sell livestock due not only to drought (as under present law), but also to floods or other weather-related conditions, may elect to include income from the sale of the livestock in the taxable year following the taxable year of the sale. This elective deferral of income is available only if the taxpayer establishes that, under the taxpayer's usual business practices, the sale would not have occurred but for the drought, flood or other weather-related conditions that resulted in the area being designated as eligible for Federal assistance.

In addition, the bill amends Code section 1033(e) to provide that the sale of livestock (other than poultry) that are held for draft, breeding, or dairy purposes in excess of the number of livestock that would have been sold but for drought (as under present law), flood or other weather-related conditions is treated as an involuntary conversion.

Effective Date

The provision applies to sales and exchanges after December 31, 1996.

2. Rules relating to denial of earned income credit on basis of disqualified income (sec. 722 of the bill and sec. 32(i) of the Code)

Present Law

For taxable years beginning after December 31, 1995, an individual is not eligible for the earned income credit if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds $2,200. This threshold is indexed for inflation. Disqualified income is the sum of:

(1) interest (taxable and tax-exempt);

(2) dividends;

(3) net rent and royalty income (if greater than zero);

(4) capital gain net income and;

(5) net passive income (if greater than zero) that is not self-employment income.

Reasons for Change

The Committee believes that lower-income farmers should not be disqualified from the earned income credit due to certain sales of livestock.

Explanation of Provision

The bill clarifies that gain or loss from the sale of livestock (as defined under section 1231(b)(3) of the Code) is disregarded for purposes of the calculation of capital gain net income under the disqualified income test of the earned income credit.

Effective Date

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

3. Mortgage financing for residences located in Presidentially declared disaster areas (sec. 723 of the bill and sec. 143 of the Code)

Present Law

Qualified mortgage bonds are private activity tax-exempt bonds issued by States and local governments acting as conduits to provide mortgage loans to first-time home buyers who satisfy specified income limits and who purchase homes that cost less than statutory maximums.

Present law waives the three buyer targeting requirements for a portion of the loans made with proceeds of a qualified mortgage bond issue if the loans are made to finance homes in statutorily prescribed economically distressed areas.

Reasons for Change

The Committee believes that availability of mortgage subsidy financing may help survivors of Presidentially declared disasters rebuild their homes.

Explanation of Provision

The bill waives the first time homebuyer requirement, the income limits, and the purchase price limits for loans to finance homes in certain Presidentially declared disaster areas. The waiver applies only during the one-year period following the date of the disaster declaration.

Effective Date

The provision applies to loans financed with bonds issued after December 31, 1996, and before January 1, 1999.

D. Provisions Relating to Small Business

1. Delay imposition of penalties for failure to make payments electronically through EFTPS until after June 30, 1998 (sec. 731 of the bill and sec. 6302 of the Code)

Present Law

Employers are required to withhold income taxes and FICA taxes from wages paid to their employees. Employers also are liable for their portion of FICA taxes, excise taxes, and estimated payments of their corporate income tax liability.

The Code requires the development and implementation of an electronic fund transfer system to remit these taxes and convey deposit information directly to the Treasury (Code sec. 6302(h)[53]). The Electronic Federal Tax Payment System ("EFTPS") was developed by Treasury in response to this requirement.[54] Employers must enroll with one of two private contractors hired by the Treasury. After enrollment, employers generally initiate deposits either by telephone or by computer.

The new system is phased in over a period of years by increasing each year the percentage of total taxes subject to the new EFTPS system. For fiscal year 1994, 3 percent of the total taxes are required to be made by electronic fund transfer. These percentages increased gradually for fiscal years 1995 and 1996. For fiscal year 1996, the percentage was 20.1 percent (30 percent for excise taxes and corporate estimated tax payments). For fiscal year 1997, these percentages increased significantly, to 58.3 percent (60 percent for excise taxes and corporate estimated tax payments). The specific implementation method required to achieve the target percentages is set forth in Treasury regulations. Implementation began with the largest depositors.

Treasury had originally implemented the 1997 percentages by requiring that all employers who deposit more than $50,000 in 1995 must begin using EFTPS by January 1, 1997. The Small Business Job Protection Act of 1996 provided that the increase in the required percentages for fiscal year 1997 (which, pursuant to Treasury regulations, was to take effect on January 1, 1997) will not take effect until July 1, 1997.[55] This was done to provide additional time prior to implementation of the 1997 requirements so that employers could be better informed about their responsibilities.

On June 2, 1997, the IRS announced[56] that it will not impose penalties through December 31, 1997, on businesses that make timely deposits using paper federal tax deposit coupons while converting to the EFTPS system.

Reasons for Change

The Committee believes that it is necessary to provide small businesses with additional time prior to implementation of the requirements so that these employers may be better informed about their responsibilities.

Explanation of Provision

The bill provides that no penalty shall be imposed solely by reason of a failure to use EFTPS prior to July 1, 1998, if the taxpayer was first required to use the EFTPS system on or after July 1, 1997.

Effective Date

The provision is effective on the date of enactment.

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[53] This requirement was enacted in 1993 (sec. 523 of P.L. 103–182).

[54] Treasury had earlier developed TAXLINK as the prototype for EFTPS. TAXLINK has been operational for several years; EFTPS is currently operational. Employers currently using TAXLINK will ultimately be required to participate in EFTPS.

[55] Sec. 1809 of P.L. 104–188.

[56] IR–97–32.

2. Repeal installment method adjustment for farmers (sec. 732 of the bill and sec. 56 of the Code)

Present Law

The installment method allows gain on the sale of property to be recognized as payments are received. Under the regular tax, dealers in personal property are not allowed to defer the recognition of income by use of the installment method on the installment sale of such property. For this purpose, dealer dispositions do not include sales of any property used or produced in the trade or business of farming. For alternative minimum tax purposes, the installment method is not available with respect to the disposition of any property that is the stock in trade of the taxpayer or any other property of a kind which would be properly included in the inventory of the taxpayer if held at year end, or property held by the taxpayer primarily for sale to customers. No explicit exception is provided for installment sales of farm property under the alternative minimum tax.

Reasons for Change

The Committee understands that the Internal Revenue Service ("IRS") takes the position that the installment method may not be used for sales of property produced on a farm for alternative minimum tax purposes. The Committee further understands that the IRS has announced that it generally will not enforce this position for taxable years beginning before January 1, 1997, so long as the farmer changes its method of accounting for installment sales for taxable years beginning after December 31, 1996.[57] The Committee disagrees with the IRS position and believes that this issue should be clarified in favor of the farmer.

Explanation of Provision

The bill generally provides that for purposes of computing alternative minimum taxable income, taxpayers may use the installment method of accounting.

Effective Date

The provision generally is effective for dispositions in taxable years beginning after December 31, 1987.

E. Foreign Tax Provisions

1. Eligibility of licenses of computer software for foreign sales corporation benefits (sec. 741 of the bill and sec. 927 of the Code)

Present Law

Under special tax provisions that provide an export benefit, a portion of the foreign trade income of an eligible foreign sales corporation ("FSC") is exempt from Federal income tax. Foreign trade income is defined as the gross income of a FSC that is attributable

[57] Notice 97–13, January 28, 1997.

to foreign trading gross receipts. The term "foreign trading gross receipts" includes the gross receipts of a FSC from the sale, lease, or rental of export property and from services related and subsidiary to such sales, leases, or rentals.

For purposes of the FSC rules, export property is defined as property (1) which is manufactured, produced, grown, or extracted in the United States by a person other than a FSC; (2) which is held primarily for sale, lease, or rental in the ordinary conduct of a trade or business by or to a FSC for direct use, consumption, or disposition outside the United States; and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. Intangible property generally is excluded from the definition of export property for purposes of the FSC rules; this exclusion applies to copyrights *other than* films, tapes, records, or similar reproductions for commercial or home use. The temporary Treasury regulations provide that a license of a master recording tape for reproduction outside the United States is not excluded from the definition of export property (Treas. Reg. sec. 1.927(a)–1T(f)(3)). The statutory exclusion for intangible property does not contain any specific reference to computer software. However, the temporary Treasury regulations provide that a copyright on computer software does not constitute export property, and that standardized, mass marketed computer software constitutes export property if such software is not accompanied by a right to reproduce for external use (Treas. Reg. sec. 1.927(a)–1T(f)(3)).

Reasons for Change

For purposes of the FSC provisions, films, tapes, records and similar reproductions explicitly are included within the definition of export property. In light of technological developments, the Committee believes that computer software is virtually indistinguishable from the enumerated films, tapes, and records. Accordingly, the Committee believes that the benefits of the FSC provisions similarly should be available to computer software.

Explanation of Provision

The bill provides that computer software licensed for reproduction abroad is *not* excluded from the definition of export property for purposes of the FSC provisions. Accordingly, computer software that is exported with a right to reproduce is eligible for the benefits of the FSC provisions. In light of the rapid innovations in the computer and software industries, the Committee intends that the term "computer software" be construed broadly to accommodate technological changes in the products produced by both industries. No inference is intended regarding the qualification as export property of computer software licensed for reproduction abroad under present law.

Effective Date

The provision applies to gross receipts from computer software licenses attributable to periods after December 31, 1997. Accordingly, in the case of a multi-year license, the provision applies to gross receipts attributable to the period of such license that is after December 31, 1997.

2. Regulations to limit treaty benefits for payments to hybrid entities (sec. 742 of the bill and sec. 894 of the Code)

Present Law

Nonresident alien individuals and foreign corporations (collectively, foreign persons) that are engaged in business in the United States are subject to U.S. tax on the income from such business in the same manner as a U.S. person. In addition, the United States imposes tax on certain types of U.S. source income, including interest, dividends and royalties, of foreign persons not engaged in business in the United States. Such tax is imposed on a gross basis and is collected through withholding. The statutory rate of this withholding tax is 30 percent. However, most U.S. income tax treaties provide for a reduction in the rate, or elimination, of this withholding tax. Treaties generally provide for different applicable withholding tax rates for different types of income. Moreover, the applicable withholding tax rates differ among treaties. The specific withholding tax rates pursuant to a treaty are the result of negotiations between the United States and the treaty partner.

The application of the withholding tax is more complicated in the case of income derived through an entity, such as a limited liability company, that is treated as a partnership for U.S. tax purposes but may be treated as a corporation for purposes of the tax laws of a treaty partner. The Treasury regulations include specific rules that apply in the case of income derived through an entity that is treated as a partnership for U.S. tax purposes. In the case of a payment of an item of U.S. source income to a U.S. partnership, the partnership is required to impose the withholding tax to the extent the item of income is includible in the distributive share of a partner who is a foreign person. Tax-avoidance opportunities may arise in applying the reduced rates of withholding tax provided under a treaty to cases involving income derived through a limited liability company or other hybrid entity (e.g., an entity that is treated as a partnership for U.S. tax purposes but as a corporation for purposes of the treaty partner's tax laws). Regulations that have been proposed but not yet finalized would address certain aspects of this issue in the case of an item received by a foreign entity by allowing an interest holder in that entity to claim a reduced rate of withholding tax with respect to that item under a treaty only if the treaty partner requires the interest holder to include in income its distributive share of the entity's income on a flow-through basis (Prop. Treas. Reg. Sec. 1.1441–6(b)(4)). This provision in the proposed regulations does not apply in the case of a U.S. entity.

Reasons for Change

The Committee is concerned about the potential tax-avoidance opportunities available for foreign persons that invest in the United States through hybrid entities. In particular, the Committee understands that the interaction of the tax laws and the applicable tax treaty may provide a business structuring opportunity that would allow foreign corporations with U.S. subsidiaries to avoid both U.S. and foreign income taxes with respect to those U.S. operations. The Committee believes that the Secretary of the Treasury should prescribe regulations to eliminate such tax-avoidance opportunities.

Explanation of Provision

The bill provides that the Secretary of the Treasury shall prescribe regulations to determine the extent to which a taxpayer shall be denied benefits under an income tax treaty of the United States with respect to any payment received by, or income attributable to activities of, an entity that is treated as a partnership for U.S. federal income tax purposes (or is otherwise treated as fiscally transparent for such purposes) but is treated as fiscally non-transparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer.

The bill addresses the potential tax-avoidance opportunity that may arise in applying the reduced rates of withholding tax provided under a treaty to cases involving income derived through a limited liability company or other hybrid entity (e.g., an entity that is treated as a partnership for U.S. tax purposes but as a corporation for purposes of the treaty partner's tax laws). Such a tax-avoidance opportunity may arise, for example, for Canadian corporations with U.S. subsidiaries because of the interaction between the U.S. tax law, the Canadian tax law, and the income tax treaty between the United States and Canada. Through the use of a U.S. limited liability company, which is treated as a partnership for U.S. tax purposes but as a corporation for Canadian tax purposes, a payment of interest (which is deductible for U.S. tax purposes) may be converted into a dividend (which is excludable for Canadian tax purposes). Accordingly, interest paid by a U.S. subsidiary through a U.S. limited liability company to a Canadian parent corporation would be deducted by the U.S. subsidiary for U.S. tax purposes and would be excluded by the Canadian parent corporation for Canadian tax purposes; the only tax on such interest would be a U.S. withholding tax, which may be imposed at a reduced rate of 10 percent (rather than the full statutory rate of 30 percent) pursuant to the income tax treaty between the United States and Canada. It is expected that the regulations will impose withholding tax at the full statutory rate of 30 percent in such case.

Effective Date

The provision is effective upon date of enactment.

3. Treatment of certain securities positions under the subpart F investment in U.S. property rules (sec. 743 of the bill and sec. 956 of the Code)

Present Law

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

A shareholder's current income inclusion with respect to a CFC's investment in U.S. property for a taxable year is based on the CFC's average investment in U.S. property for such year. For this purpose, the U.S. property held by the CFC must be measured as of the close of each quarter in the taxable year. U.S. property generally is defined to include tangible property located in the United States, stock of a U.S. corporation, obligations of a U.S. person, and the right to use certain intellectual property in the United States. Exceptions are provided for, among other things, obligations of the United States, U.S. bank deposits, certain trade or business obligations, and stock or debts of certain unrelated U.S. corporations.

Reasons for Change

The Committee believes that guidance is needed regarding the treatment of certain transactions entered into by securities dealers in the ordinary course of business under the investment in U.S. property provisions of subpart F. The Committee believes that deposits of collateral or margin in the ordinary course of business should not give rise to an income inclusion as an investment in U.S. property under the provisions of subpart F. Similarly, the Committee believes that repurchase agreements entered into in the ordinary course of business should not give rise to an income inclusion as an investment in U.S. property.

Explanation of Provision

The bill provides two additional exceptions from the definition of U.S. property for purposes of the subpart F rules. Both exceptions relate to transactions entered into by a securities or commodities dealer in the ordinary course of its business as a securities or commodities dealer.

The first exception covers the deposit of collateral or margin by a securities or commodities dealer, or the receipt of such a deposit by a securities or commodities dealer, if such deposit is made or received on commercial terms in the ordinary course of the dealer's business as a securities or commodities dealer. This exception applies to deposits of margin or collateral for securities loans, notional principal contracts, options contracts, forward contracts, futures contracts, and any other financial transaction with respect to which the Secretary of the Treasury determines that the posting of collateral or margin is customary.

The second exception covers repurchase agreement transactions and reverse repurchase agreement transactions entered into by or with a securities or commodities dealer in the ordinary course of its business as a securities or commodities dealer. The exception applies only to the extent that the obligation under the transaction does not exceed the fair market value of readily marketable securities transferred or otherwise posted as collateral.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 1997, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

4. Exception from foreign personal holding company income under subpart F for active financing income (sec. 744 of the bill and sec. 954 of the Code)

Present Law

Under the subpart F rules, certain U.S. shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income" and insurance income. The U.S. 10-percent shareholders of a CFC also are subject to current inclusion with respect to their shares of the CFC's foreign base company services income (i.e., income derived from services performed for a related person outside the country in which the CFC is organized).

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1) property that gives rise to the preceding types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization, as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other-country risks. Investment income of a CFC that is allocable to any insurance or annuity contract related to risks located outside the CFC's country of organization is taxable as subpart F insurance income (Prop. Treas. reg. sec. 1.953–1(a)). Investment income allocable to risks located within the CFC's country of organization generally is taxable as foreign personal holding company income.

Reasons for Change

The subpart F rules historically have been aimed at requiring current inclusion by the U.S. shareholders of income of a CFC that is either passive or easily movable. Prior to the enactment of the 1986 Act, exceptions from foreign personal holding company income were provided for income derived in the conduct of a banking, financing, or similar business or derived from certain investments made by an insurance company. The Committee is concerned that the 1986 Act's repeal of these exceptions has resulted in the extension of the subpart F provisions to income that is neither passive nor easily moveable. The Committee believes that the provision of exceptions from foreign personal holding company income for income from the active conduct of an insurance, banking, financing or similar business is appropriate.

Explanation of Provision

The bill provides a temporary exception from foreign personal holding company income for subpart F purposes for certain income that is derived in the active conduct of an insurance, banking, financing or similar business. Such exception is applicable only for taxable years beginning in 1998.

Under the bill, foreign personal holding company income does not include income that is derived in or incident to the active conduct of a banking, financing or similar business by a CFC that is predominantly engaged in the active conduct of such business. For this purpose, income derived in the active conduct of a banking, financing, or similar business generally is determined under the principles applicable in determining financial services income for foreign tax credit limitation purposes. Moreover, the Secretary of the Treasury shall prescribe regulations applying look-through treatment in characterizing for this purpose dividends, interest, income equivalent to interest, rents, and royalties from related persons. A CFC is considered to be predominantly engaged in the active conduct of a banking, financing, or similar business if (1) more than 70 percent of its gross income is derived from transactions with unrelated persons and more than 20 percent of its gross income from that business is derived from transactions with unrelated persons located within the country in which the CFC is organized or incorporated, or (2) the CFC is predominantly engaged in the active conduct of a banking or securities business, or is a qualified bank or securities affiliate, as defined for purposes of the passive foreign investment company provisions.

Under the bill, foreign personal holding company income also does not include certain investment income of a qualifying insurance company with respect to risks located within the CFC's country of organization. These exceptions apply to income derived from investments of assets equal to the total of (1) unearned premiums and reserves ordinary and necessary for the proper conduct of the CFC's insurance business, (2) one-third of premiums earned during the taxable year on insurance contracts regulated in the country in which sold as property, casualty, or health insurance contracts, and (3) the greater of $10 million or 10 percent of reserves for insurance contracts regulated in the country in which sold as life insurance or annuity contracts. For this purpose, a qualifying insurance company is an entity that is subject to regulation as an insurance company under the laws of its country of incorporation and that realizes at least 50 percent of its gross income (other than income from investments) from premiums related to risks located within such country. The bill's exceptions for insurance investment income do not apply to investment income which is received by the CFC from a related person. Similarly, the exceptions do not apply to investment income that is attributable directly or indirectly to the insurance or reinsurance of risks of related persons. The bill does not change the rule of present law that investment income of a CFC that is attributable to the issuing or reinsuring any insurance or annuity contract related to risks outside of its country of organization is taxable as Subpart F insurance income.

The bill also provides an exception from foreign base company services income for income derived from services performed in connection with the active conduct of a banking, financing, insurance or similar business by a CFC that is predominantly engaged in the active conduct of such business.

Effective Date

The provision applies only to taxable years of foreign corporations beginning in 1998, and to taxable years of United States shareholders with or within which such taxable years of foreign corporations end.

5. Treat service income of nonresident alien individuals earned on foreign ships as foreign source income and disregard the U.S. presence of such individuals (sec. 745 of the bill and secs. 861, 863, 872, 3401, and 7701 of the Code)

Present Law

Nonresident alien individuals generally are subject to U.S. taxation and withholding on their U.S. source income. Compensation for labor and personal services performed within the United States is considered U.S. source unless such income qualifies for a de minimis exception. To qualify for the exception, the compensation paid to a nonresident alien individual must not exceed $3,000, the compensation must reflect services performed on behalf of a foreign employer, and the individual must be present in the United Sates for not more than 90 days during the taxable year. Special rules apply to exclude certain items from the gross income of a nonresident alien. An exclusion applies to gross income derived by a nonresident alien individual from the international operation of a ship if the country in which such individual is resident provides a reciprocal exemption for U.S. residents. However, this exclusion does not apply to income from personal services performed by an individual crew member on board a ship. Consequently, wages exceeding $3,000 in a taxable year that are earned by nonresident alien individual crew members of a foreign ship while the vessel is within U.S. territory are subject to income taxation by the United States.

U.S. residents are subject to U.S. tax on their worldwide income. In general, a non-U.S. citizen is considered to be a resident of the United States if the individual (1) has entered the United States as a lawful permanent U.S. resident or (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time—183 or more days—during a three-year period computed by weighting toward the present year (the “substantial presence test’). An individual generally is treated as present in the United States on any day if such individual is physically present in the United

States at any time during the day. Certain categories of individuals (e.g., foreign government employees and certain students) are not treated as U.S. residents even if they are present in the United States for the requisite period of time. Crew members of a foreign vessel who are on board the vessel while it is stationed within U.S. territorial waters are treated as present in the United States.

Reasons for Change

The Committee understands that U.S. tax rules impose a significant compliance burden on nonresident alien individuals who are present in the United States for short periods of time as members of the regular crew of a foreign vessel and who may not be permitted to leave such vessel during those periods. The Committee believes that an exemption from U.S. tax is appropriate for the income earned by a nonresident alien individual from personal services performed as a member of the regular crew of a foreign vessel. Moreover, the Committee believes that such an individual's presence in the United States as a regular crew member of a foreign vessel should not be taken into account for purposes of determining whether the individual is treated as a resident alien for U.S. tax purposes.

Explanation of Provision

The bill treats gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship as income from foreign sources. Thus, such income is exempt from U.S. income and withholding tax. However, such persons are not excluded for purposes of applying the minimum participation standards of section 410 to a plan of the employer. In addition, for purposes of determining whether an individual is a U.S. resident under the substantial presence test, the bill provides that the days that such individual is present as a member of the regular crew of a foreign vessel are disregarded.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

6. Modification of passive foreign investment company provisions to eliminate overlap with subpart F and to allow mark-to-market election (secs. 751–753 of the bill and secs. 1291–1297 of the Code)

Present Law

Overview

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. A foreign corporation generally is not subject to U.S. tax on its income from operations outside the United States.

Income of a foreign corporation generally is taxed by the United States when it is repatriated to the United States through payment to the corporation's U.S. shareholders, subject to a foreign tax credit. However, a variety of regimes imposing current U.S. tax on income earned through a foreign corporation have been reflected in the Code. Today the principal anti-deferral regimes set forth in the Code are the controlled foreign corporation rules of subpart F (secs. 951–964) and the passive foreign investment company rules (secs. 1291–1297). Additional anti-deferral regimes set forth in the Code are the foreign personal holding company rules (secs. 551–558); the personal holding company rules (secs. 541–547); the accumulated earnings tax (secs. 531–537); and the foreign investment company and electing foreign investment company rules (secs. 1246–1247). The anti-deferral regimes included in the Code overlap such that a given taxpayer may be subject to multiple sets of anti-deferral rules.

Controlled foreign corporations

A controlled foreign corporation (CFC) is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also stock owned indirectly or constructively (sec. 958).

Certain income of a CFC (referred to as "subpart F income") is subject to current U.S. tax. The United States generally taxes the U.S. 10-percent shareholders of a CFC currently on their pro rata shares of the subpart F income of the CFC. In effect, the Code treats those U.S. shareholders as having received a current distribution out of the CFC's subpart F income. Such shareholders also are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in U.S. property. The foreign tax credit may reduce the U.S. tax on these amounts.

Passive foreign investment companies

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies (PFICs). A PFIC is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income. Two alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders include currently in gross income their respective shares of the PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), under which the U.S. shareholders pay tax on income realized from the PFIC and an interest charge that is attributable to the value of deferral.

Overlap between subpart F and the PFIC provisions

A foreign corporation that is a CFC is also a PFIC if it meets the passive income test or the passive asset test described above. In such a case, the 10-percent U.S. shareholders are subject both to the subpart F provisions (which require current inclusion of certain earnings of the corporation) and to the PFIC provisions (which impose an interest charge on amounts distributed from the corporation and gains recognized upon the disposition of the corporation's stock, unless an election is made to include currently all of the corporation's earnings).

Reasons for Change

The anti-deferral rules for U.S. persons owning stock in foreign corporations are very complex. Moreover, the interactions between the anti-deferral regimes cause additional complexity. The overlap between the subpart F rules and the PFIC provisions is of particular concern to the Committee. The PFIC provisions, which do not require a threshold level of ownership by U.S. persons, apply where the U.S.-ownership requirements of subpart F are not satisfied. However, the PFIC provisions also apply to a U.S. shareholder that is subject to the current inclusion rules of subpart F with respect to the same corporation. The Committee believes that the additional complexity caused by this overlap is unnecessary.

The Committee also understands that the interest-charge method for income inclusion provided in the PFIC rules is a substantial source of complexity for shareholders of PFICs. Even without eliminating the interest-charge method, significant simplification can be achieved by providing an alternative income inclusion method for shareholders of PFICs. Further, some taxpayers have argued that they would have preferred choosing the current-inclusion method afforded by the qualified fund election, but were unable to do so because they could not obtain the necessary information from the PFIC. Accordingly, the Committee believes that a mark-to-market election would provide PFIC shareholders with a fair alternative method for including income with respect to the PFIC.

Explanation of Provision

Elimination of overlap between subpart F and the PFIC provisions

In the case of a PFIC that is also a CFC, the bill generally treats the corporation as not a PFIC with respect to certain 10-percent shareholders. This rule applies if the corporation is a CFC (within the meaning of section 957(a)) and the shareholder is a U.S. shareholder (within the meaning of section 951(b)) of such corporation (i.e., if the shareholder is subject to the current inclusion rules of subpart F with respect to such corporation). Moreover, the rule applies for that portion of the shareholder's holding period with respect to the corporation's stock which is after December 31, 1997 and during which the corporation is a CFC and the shareholder is a U.S. shareholder. Accordingly, a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally is not subject also to the

PFIC provisions with respect to the same stock. The PFIC provisions continue to apply in the case of a PFIC that is also a CFC to shareholders that are not subject to subpart F (i.e., to shareholders that are U.S. persons and that own (directly, indirectly, or constructively) less than 10 percent of the corporation's stock by vote).

If a shareholder of a PFIC is subject to the rules applicable to nonqualified funds before becoming eligible for the special rules provided under the proposal for shareholders that are subject to subpart F, the stock held by such shareholder continues to be treated as PFIC stock unless the shareholder makes an election to pay tax and an interest charge with respect to the unrealized appreciation in the stock or the accumulated earnings of the corporation.

If, under the bill, a shareholder is not subject to the PFIC provisions because the shareholder is subject to subpart F and the shareholder subsequently ceases to be subject to subpart F with respect to the corporation, for purposes of the PFIC provisions, the shareholder's holding period for such stock is treated as beginning immediately after such cessation. Accordingly, in applying the rules applicable to PFICs that are not qualified electing funds, the earnings of the corporation are not attributed to the period during which the shareholder was subject to subpart F with respect to the corporation and was not subject to the PFIC provisions.

Mark-to-market election

The bill allows a shareholder of a PFIC to make a mark-to-market election with respect to the stock of the PFIC, provided that such stock is marketable (as defined below). Under such an election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder is allowed a deduction for the excess, if any, of the adjusted basis of the PFIC stock over its fair market value as of the close of the taxable year. However, deductions are allowable under this rule only to the extent of any net mark-to-market gains with respect to the stock included by the shareholder for prior taxable years.

Under the bill, this mark-to-market election is available only for PFIC stock that is "marketable." For this purpose, PFIC stock is considered marketable if it is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission or on the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934. In addition, PFIC stock is considered marketable if it is regularly traded on any exchange or market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a legitimate and sound fair market value. Any option on stock that is considered marketable under the foregoing rules is treated as marketable, to the extent provided in regulations. PFIC stock also is treated as marketable, to the extent provided in regulations, if the PFIC offers for sale (or has outstanding) stock of which it is the issuer and which is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the bill treats as marketable any PFIC stock owned by a RIC that offers for sale (or has outstanding) any stock of which it is the issuer and which is redeemable at its net asset value. The bill treats as marketable any PFIC stock held by any other RIC that otherwise publishes net asset valuations at least annually, except to the extent provided in regulations. It is believed that even for RICs that do not make a market in their own stock, but that do regularly report their net asset values in compliance with the securities laws, inaccurate valuation may bring exposure to legal liabilities, and this exposure may ensure the reliability of the values such RICs assign to the PFIC stock they hold.

The shareholder's adjusted basis in the PFIC stock is adjusted to reflect the amounts included or deducted under this election. In the case of stock owned indirectly by a U.S. person through a foreign entity (as discussed below), the basis adjustments for mark-to-market gains and losses apply to the basis of the PFIC in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFIC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFIC stock.

Amounts included in income pursuant to a mark-to-market election, as well as gain on the actual sale or other disposition of the PFIC stock, is treated as ordinary income. Ordinary loss treatment also applies to the deductible portion of any mark-to-market loss on PFIC stock, as well as to any loss realized on the actual sale or other disposition of PFIC stock to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included with respect to such stock. The source of amounts with respect to a mark-to-market election generally is determined in the same manner as if such amounts were gain or loss from the sale of stock in the PFIC.

An election to mark to market applies to the taxable year for which made and all subsequent taxable years, unless the PFIC stock ceases to be marketable or the Secretary of the Treasury consents to the revocation of such election.

Under constructive ownership rules, U.S. persons that own PFIC stock through certain foreign entities may make this election with respect to the PFIC. These constructive ownership rules apply to treat PFIC stock owned directly or indirectly by or for a foreign partnership, trust, or estate as owned proportionately by the partners or beneficiaries, except as provided in regulations. Stock in a PFIC that is thus treated as owned by a person is treated as actually owned by that person for purposes of again applying the constructive ownership rules. In the case of a U.S. person that is treated as owning PFIC stock by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the PFIC stock, as well as any disposition by the person actually owning the PFIC stock, is treated as a disposition by the U.S. person of the PFIC stock.

In addition, a CFC that owns stock in a PFIC is treated as a U.S. person that may make the election with respect to such PFIC stock. Any amount includible (or deductible) in the CFC's gross income pursuant to this mark-to-market election is treated as foreign personal holding company income (or a deduction allocable to foreign personal holding company income). The source of such amounts, however, is determined by reference to the actual residence of the CFC.

In the case of a taxpayer that makes the mark-to-market election with respect to stock in a PFIC that is a nonqualified fund after the beginning of the taxpayer's holding period with respect to such stock, a coordination rule applies to ensure that the taxpayer does not avoid the interest charge with respect to amounts attributable to periods before such election. A similar rule applies to RICs that make the mark-to-market election under this bill after the beginning of their holding period with respect to PFIC stock (to the extent that the RIC had not previously marked to market the stock of the PFIC).

Except as provided in the coordination rules described above, the rules of section 1291 (with respect to nonqualified funds) do not apply to a shareholder of a PFIC if a mark-to-market election is in effect for the shareholder's taxable year. Moreover, in applying section 1291 in a case where a mark-to-market election was in effect for any prior taxable year, the shareholder's holding period for the PFIC stock is treated as beginning immediately after the last taxable year for which such election applied.

A special rule applicable in the case of a PFIC shareholder that becomes a U.S. person treats the adjusted basis of any PFIC stock held by such person on the first day of the year in which such shareholder becomes a U.S. person as equal to the greater of its fair market value on such date or its adjusted basis on such date. Such rule applies only for purposes of the mark-to-market election.

Effective Date

The provision is effective for taxable years of U.S. persons beginning after December 31, 1997, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

F. Other Provisions

1. Tax-exempt status for certain State workmen's compensation act companies (sec. 761 of the bill and sec. 501(c)(27) of the Code)

Present Law

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

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

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

Reasons for Change

The Committee believes that eliminating uncertainty concerning the eligibility of certain State workmen's compensation act companies for tax-exempt status will assist States in ensuring that workmen's compensation coverage is provided for employers with respect to employees in the State. While tax exemption may be available under present law for many of these entities, the Committee believes that it is appropriate to clarify standards for tax-exempt status.

Explanation of Provision

The bill clarifies the tax-exempt status of any organization that is created by State law, and organized and operated exclusively to provide workmen's compensation insurance and related coverage that is incidental to workmen's compensation insurance,[58] and that meets certain additional requirements. The workmen's compensation insurance must be required by State law, or be insurance with respect to which State law provides significant disincentives if it is not purchased by an employer (such as loss of exclusive remedy or forfeiture of affirmative defenses such as contributory negligence). The organization must provide workmen's compensation to any employer in the State (for employees in the State or temporarily assigned out-of-State) seeking such insurance and meeting other reasonable requirements. The State must either extend its full faith and credit to debt of the organization or provide the initial operating capital of such organization. For this purpose, the initial operating capital can be provided by providing the proceeds of bonds issued by a State authority; the bonds may be repaid through exercise of the State's taxing authority, for example. For periods after the date of enactment, the assets of the organization must revert to the State upon dissolution. Finally, the majority of the board of directors (or comparable oversight body) of the organization must be appointed by an official of the executive branch of the State or by the State legislature, or by both.

[58] Related coverage that is incidental to workmen's compensation insurance includes liability under Federal workmen's compensation laws, the Jones Act, and the Longshore and Harbor Workers Compensation Act, for example.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997. Many organizations described in the provision have been operating as tax-exempt organizations. No inference is intended that organizations described in the provision are not tax-exempt under present law.

2. Election to continue exception from treatment of publicly traded partnerships as corporations (sec. 762 of the bill and sec. 7704 of the Code)

Present Law

A publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704). An exception to the rule treating the partnership as a corporation applies if 90 percent of the partnership's gross income consists of "passive-type income," which includes (1) interest (other than interest derived in a financial or insurance business, or certain amounts determined on the basis of income or profits), (2) dividends, (3) real property rents (as defined for purposes of the provision), (4) gain from the sale or other disposition of real property, (5) income and gains relating to minerals and natural resources (as defined for purposes of the provision), and (6) gain from the sale or disposition of a capital asset (or certain trade or business property) held for the production of income of the foregoing types (subject to an exception for certain commodities income).

The exception for publicly traded partnerships with "passive-type income" does not apply to any partnership that would be described in section 851(a) of the Code (relating to regulated investment companies, or "RICs"), if that partnership were a domestic corporation. Thus, a publicly traded partnership that is registered under the Investment Company Act of 1940 generally is treated as a corporation under the provision. Nevertheless, if a principal activity of the partnership consists of buying and selling of commodities (other than inventory or property held primarily for sale to customers) or futures, forwards and options with respect to commodities, and 90 percent of the partnership's income is such income, then the partnership is not treated as a corporation.

A publicly traded partnership is a partnership whose interests are (1) traded on an established securities market, or (2) readily tradable on a secondary market (or the substantial equivalent thereof).

Treasury regulations provide detailed guidance as to when an interest is treated as readily tradable on a secondary market or the substantial equivalent. Generally, an interest is so treated "if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market" (Treas. Reg. sec. 1.7704–1(c)(1)).

When the publicly traded partnership rules were enacted in 1987, a 10-year grandfather rule provided that the provisions apply to certain existing partnerships only for taxable years beginning after December 31, 1997.[59] An existing publicly traded partnership is any partnership, if (1) it was a publicly traded partnership on December 17, 1987, (2) a registration statement indicating that the partnership was to be a publicly traded partnership was filed with the Securities and Exchange Commission with respect to the partnership on or before December 17, 1987, or (3) with respect to the partnership, an application was filed with a State regulatory commission on or before December 31, 1987, seeking permission to restructure a portion of a corporation as a publicly traded partnership. A partnership that otherwise would be treated as an existing publicly traded partnership ceases to be so treated as of the first day after December 17, 1987, on which there has been an addition of a substantial new line of business with respect to such partnership. A rule is provided to coordinate this grandfather rule with the exception to the rule treating the partnership as a corporation applies if 90 percent of the partnership's gross income consists of passive-type income. The coordination rule provides that passive-type income exception applies only after the grandfather rule ceases to apply (whether by passage of time or because the partnership ceases to qualify for the grandfather rule).

Reasons for Change

The Committee believes that, in important respects, publicly traded partnerships generally resemble corporations and should be subject to tax as corporations, so long as the current corporate income tax applies to corporate entities. Nevertheless, in the case of certain publicly traded partnerships that were existing on December 17, 1987, and that are treated as partnerships under the grandfather rule until December 31, 1997, it is appropriate to permit the continuation of their status as partnerships, so long as they elect to be subject to a tax that is intended to approximate the corporate tax they would pay if they were treated as corporations for Federal tax purposes.

Explanation of Provision

In the case of an existing publicly traded partnership that elects under the provision to be subject to a tax on gross income from the active conduct of a trade or business, the rule of present law treating a publicly traded partnership as a corporation does not apply. An existing publicly traded partnership is any publicly traded partnership that is not treated as a corporation, so long as such treatment is not determined under the passive-type income exception of Code section 7704(c)(1). The election to be subject to the tax on gross trade or business income, once made, remains in effect until revoked by the partnership, and cannot be reinstated.

The tax is 3.5 percent of the partnership's gross income from the active conduct of a trade or business. The partnership's gross trade or business income includes its share of gross trade or business income of any lower-tier partnership. The tax imposed under the provision may not be offset by tax credits.

[59] Omnibus Budget Reconciliation Act of 1987 (P.L. 100–203), sec. 10211(c).

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

3. Exclusion from UBIT for certain corporate sponsorship payments (sec. 763 of the bill and sec. 513 of the Code)

Present Law

Although generally exempt from Federal income tax, tax-exempt organizations are subject to the unrelated business income tax ("UBIT") on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization's tax-exempt functions (secs. 511–514). Contributions or gifts received by tax-exempt organizations generally are not subject to the UBIT. However, present-law section 513(c) provides that an activity (such as advertising) does not lose its identity as a separate trade or business merely because it is carried on within a larger complex of other endeavors.[60] If a tax-exempt organization receives sponsorship payments in connection with an event or other activity, the solicitation and receipt of such sponsorship payments may be treated as a separate activity. The Internal Revenue Service (IRS) has taken the position that, under some circumstances, such sponsorship payments are subject to the UBIT.[61]

Reasons for Change

In order to reduce the uncertainty regarding the treatment for UBIT purposes of corporate sponsorship payments received by tax-exempt organizations, the Committee believes that it is appropriate to distinguish sponsorship payments for which the donor receives no substantial return benefit other than the use or acknowledgment of the donor's name or logo as part of a sponsored event (which should not be subject to the UBIT) from payments made in exchange for advertising provided by the recipient organization (which should be subject to the UBIT).

Explanation of Provision

Under the bill, qualified sponsorship payments received by a tax-exempt organization (or State college or university described in section 511(a)(2)(B)) are exempt from the UBIT.

"Qualified sponsorship payments" are defined as any payment made by a person engaged in a trade or business with respect to which the person will receive no substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the orga-

[60] See *United States* v. *American College of Physicians,* 475 U.S. 834 (1986) (holding that activity of selling advertising in medical journal was not substantially related to the organization's exempt purposes and, as a separate business under section 513(c), was subject to tax).

[61] See Prop. Treas. Reg. sec. 1.513–4 (issued January 19, 1993, EE–74–92, IRB 1993–7, 71). These proposed regulations generally exclude from the UBIT financial arrangements under which the tax-exempt organization provides so-called "institutional" or "good will" advertising to a sponsor (i.e., arrangements under which a sponsor's name, logo, or product line is acknowledged by the tax-exempt organization). However, specific product advertising (e.g., "comparative or qualitative descriptions of the sponsor's products") provided by a tax-exempt organization on behalf of a sponsor is not shielded from the UBIT under the proposed regulations.

nization's activities.[62] Such a use or acknowledgment does *not* include advertising of such person's products or services—meaning qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell, or use such products or services. Thus, for example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event conducted by the organization, such payment will not be subject to the UBIT. In contrast, if the organization provides advertising of a sponsor's products, the payment made to the organization by the sponsor in order to receive such advertising will be subject to the UBIT (provided that the other, present-law requirements for UBIT liability are satisfied).

The bill specifically provides that a qualified sponsorship payment does not include any payment where the amount of such payment is contingent, by contract or otherwise, upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to an activity. However, the fact that a sponsorship payment is contingent upon an event actually taking place or being broadcast, in and of itself, will not cause the payment to fail to be a qualified sponsorship payment. Moreover, mere distribution or display of a sponsor's products by the sponsor or the tax-exempt organization to the general public at a sponsored event, whether for free or for remuneration, will be considered to be "use or acknowledgment" of the sponsor's product lines (as opposed to advertising), and thus will not affect the determination of whether a payment made by the sponsor is a qualified sponsorship payment.

The provision does not apply to the sale of advertising or acknowledgments in tax-exempt organization periodicals. For this purpose, the term "periodical" means regularly scheduled and printed material published by (or on behalf of) the payee organization that is not related to and primarily distributed in connection with a specific event conducted by the payee organization. For example, the provision will not apply to payments that lead to acknowledgments in a monthly journal, but will apply if a sponsor receives an acknowledgment in a program or brochure distributed at a sponsored event.

The provision specifically provides that, to the extent that a portion of a payment would (if made as a separate payment) be a qualified sponsorship payment, such portion of the payment will be treated as a separate payment. Thus, if a sponsorship payment made to a tax-exempt organization entitles the sponsor to both product advertising and use or acknowledgment of the sponsor's name or logo by the organization, then the UBIT will not apply to the amount of such payment that exceeds the fair market value of the product advertising provided to the sponsor. Moreover, the provision of facilities, services or other privileges by an exempt organization to a sponsor or the sponsor's designees (e.g., complimentary tickets, pro-am playing spots in golf tournaments, or receptions for

[62] In determining whether a payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the organization's exempt purpose.

major donors) in connection with a sponsorship payment will not affect the determination of whether the payment is a qualified sponsorship payment. Rather, the provision of such goods or services will be evaluated as a separate transaction in determining whether the organization has unrelated business taxable income from the event. In general, if such services or facilities do not constitute a substantial return benefit or if the provision of such services or facilities is a related business activity, then the payments attributable to such services or facilities will not be subject to the UBIT. Moreover, just as the provision of facilities, services or other privileges by a tax-exempt organization to a sponsor or the sponsor's designees (complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) will be treated as a separate transaction that does not affect the determination of whether a sponsorship payment is a qualified sponsorship payment, a sponsor's receipt of a license to use an intangible asset (e.g., trademark, logo, or designation) of the tax-exempt organization likewise will be treated as separate from the qualified sponsorship transaction in determining whether the organization has unrelated business taxable income.

The exemption provided by the provision will be in addition to other present-law exceptions from the UBIT (e.g., the exceptions for activities substantially all the work for which is performed by volunteers and for activities not regularly carried on). No inference is intended as to whether any sponsorship payment received prior to 1998 was subject to the UBIT.

Effective Date

The provision applies to qualified sponsorship payments solicited or received after December 31, 1997.

4. Timeshare associations (sec. 764 of the bill and sec. 528 of the Code)

Present Law

Taxation of homeowners associations making the section 528 election.—Under present law (sec. 528), condominium management associations and residential real estate management associations may elect to be taxable at a 30 percent rate on their "homeowners association income" if they meet certain income, expenditure, and organizational requirements.

"Homeowners association income" is the excess of the association's gross income, excluding "exempt function income," over allowable deductions directly connected with non-exempt function gross income. "Exempt function income" includes membership dues, fees, and assessments for a common activity undertaken by association members or owners of residential units in the condominium or subdivision. Homeowners association income includes passive income (*e.g.*, interest and dividends) earned on reserves and fees for use of association property (*e.g.*, swimming pools, meeting rooms, etc.).

For an association to qualify for this treatment, (1) at least 60 percent of the association's gross income must consist of membership dues, fees, or assessments on owners, (2) at least 90 percent of its expenditures must be for the acquisition, management, maintenance, or care of "association property," and (3) no part of its net earnings can inure to the benefit of any private shareholder. "Association property" means: (1) property held by the association; (2) property commonly held by association members; (3) property within the association privately held by association members; and (4) property held by a governmental unit for the benefit of association members. In addition to these statutory requirements, Treasury regulations require that the units of the association be used for residential purposes. Use is not a residential use if the unit is occupied by a person or series of persons less than 30 days for more than half of the association's taxable year. Treas. Reg. sec. 1.528–4(d).

Taxation of homeowners associations not making the section 528 election.—Homeowners associations that do not (or cannot) make the section 528 election are taxed either as a tax-exempt social welfare organization under section 501(c)(4) or as a regular C corporation. In order for an organization to qualify as a tax-exempt social welfare organization, the organization must meet the following three requirements: (1) the association must serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit; (2) the association may not conduct activities directed to exterior maintenance of any private residence, and (3) common areas of association facilities must be for the use and enjoyment of the general public (Rev. Rul. 74–99, 1974–1 C.B. 131).

Non-exempt homeowners associations are taxed as C corporations, except that (1) the association may exclude excess assessments that it refunds to its members or applies to the subsequent year's assessments (Rev. Rul. 70–604, 1970–2 C.B. 9); (2) gross income does not include special assessments held in a special bank account (Rev. Rul. 75–370, 75–2 C.B. 25), and (3) assessments for capital improvements are treated as non-taxable contributions to capital (Rev. Rul. 75–370, 1975–2 C.B. 25).

Taxation of timeshare associations.—Under present law, timeshare associations are taxed as regular C corporations because (1) they cannot meet the requirement of the Treasury regulations for the section 528 election that the units be used for residential purposes (i.e., the 30-day rule) and they have relatively large amount of services performed for its owners (e.g., maid and janitorial services) and (2) they cannot meet any of requirements of Rev. Rul. 74–99 for tax-exempt status under section 501(c)(4).

Reasons for Change

The committee understands that the IRS recently has challenged the exclusions from gross income of timeshare associations of refunds of excess assessments, special assessments held in a segregated account, and capital assessments as contributions to capital. See P.L.R. 9539001 (June 8, 1995). The committee believes that the activities of timeshare associations are sufficiently similar to those of homeowners associations that they should be similarly taxed. Accordingly, the committee bill would extend the rules for the taxation of homeowners associations to timeshare associations, except that the rate of tax on timeshare associations is 32 percent, instead of the 30-percent rate that applies to homeowner's associations.

Explanation of Provision

The bill amends section 528 to permit timeshare associations to qualify for taxation under that section. Timeshare associations would have to meet the requirements of section 528 (e.g., the 60 percent gross income, 90 percent expenditure, and the non-profit organizational and operational requirements). Timeshare associations electing to be taxed under section 528 are subject to a tax on their "timeshare association income" at a rate of 32 percent.

60-Percent Test

A qualified timeshare association must receive at least 60 percent of its income from membership dues, fees and assessments from owners of either (a) timeshare rights to use of, or (b) timeshare ownership in, property the timeshare association.

90-Percent Test

At least 90 percent of the expenditures of the timeshare association must be for the acquisition, management, maintenance, or care of "association property," and activities provided by the association to, or on behalf of, members of the timeshare association. "Activities provided to or on behalf of members of the [timeshare] association" includes events located on association property (*e.g.,* member's meetings at the association's meeting room, parties at the association's swimming pool, golf lessons on association's golf range, transportation to and from association property, etc.).

Organizational and Operational Tests

No part of the net earnings of the timeshare association can inure to the benefit (other than by acquiring, constructing, or providing management, maintenance, and care of property of the timeshare association or rebate of excess membership dues, fees, or assessments) of any private shareholder or individual. A member of a qualified timeshare association must hold a timeshare right to use (or timeshare ownership in) real property of the association. Property of a timeshare association includes property in which a timeshare association or members of the association have rights arising out of recorded easements, covenants, and other recorded instruments to use property related to the timeshare project. A qualified timeshare association cannot be a condominium management association. Lastly, the timeshare association must elect to be taxed under section 528.

Effective Date

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

5. Deduction for business meals for individuals operating under Department of Transportation hours of service limitations and certain seafood processors (sec. 765 of the bill and sec. 274(n) of the Code)

Present Law

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

Reasons for Change

Individuals subject to the hours of service limitations of the Department of Transportation, as well as workers at remote seafood processing facilities in Alaska, are frequently forced to eat meals away from home in circumstances where their choice is limited, prices comparatively high and the opportunity for lavish meals remote. The Committee believes that it is appropriate to allow a higher percentage of the cost of food and beverages consumed while away from home by these individuals to be deducted than is allowed under the general rule.

Explanation of Provision

The bill increases to 80 percent the deductible percentage of the cost of food and beverages consumed (1) while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation and (2) by workers at remote seafood processing facilities located in the United States north of 53 degrees north latitude. A seafood processing facility is remote when there are insufficient eating facilities in the vicinity of the employer's premises.[63]

Individuals subject to the hours of service limitations of the Department of Transportation include:

(1) certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,

(2) interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,

(3) certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel pursuant to Federal Railroad Administration regulations, and

(4) certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage is phased in according to the following schedule:

[63] See Treas. Reg. sec. 1.119–1(a)(2)(ii)(c) and 1.119–1(f) (Example 7).

Taxable years beginning in:	Deductible percentage
1998, 1999	55
2000, 2001	60
2002, 2003	65
2004, 2005	70
2006, 2007	75
2008 and thereafter	80

Effective Date

The provision is effective for taxable years beginning after 1997.

6. Provide above-the-line deduction for certain business expenses (sec. 766 of the bill and sec. 62 of the Code)

Present Law

Under present law, individuals may generally deduct ordinary and necessary business expenses in determining adjusted gross income ("AGI'). This deduction does not apply in the case of an individual performing services as an employee. Employee business expenses are generally deductible only as a miscellaneous itemized deduction, i.e., only to the extent all the taxpayer's miscellaneous itemized deductions exceed 2 percent of the taxpayer's AGI. Employee business expenses are not allowed as a deduction for alternative minimum tax purposes.

Reasons for Change

The Committee is aware that certain State and local government officials are compensated (in whole or in part) on a fee basis to provide certain services to the government. These officials hire employees and incur expenses in connection with their official duties. These expenses may be subject, under present law, to the 2-percent floor on itemized deductions. The Committee believes these expenses should be deductible.

Explanation of Provision

Under the bill, employee business expenses relating to service as an official of a State or local government (or political subdivision thereof) are deductible in computing AGI ("above the line'), provided the official is compensated in whole or in part on a fee basis. Consequently, such expenses are also deductible for minimum tax purposes.

Effective Date

The provision applies to expenses paid or incurred in taxable years beginning after December 31, 1997.

7. Increase in standard mileage rate for purposes of computing charitable deduction (sec. 767 of the bill and sec. 170(i) of the Code)

Present Law

In general, individuals who itemize their deductions may deduct charitable contributions. For purposes of computing the charitable deduction for the use of a passenger automobile, the standard mileage rate is 12 cents per mile (sec. 170(i)).

Reasons for Change

The Committee believes that this rate should be increased and indexed for inflation.

Explanation of Provision

The bill increases this mileage rate to 15 cents per mile. This rate is indexed for inflation, rounded down to the nearest whole cent.

Effective Date

The increase to 15 cents is effective for taxable years beginning after December 31, 1997. The indexation is effective for inflation occurring after 1997. Accordingly, the first adjustment for indexing will occur in 1999 to reflect inflation in 1998.

8. Expensing of environmental remediation costs ("brownfields") (sec. 768 of the bill and sec. 162 of the Code)

Present Law

Code section 162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury Regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. Section 263(a)(1) limits the scope of section 162 by prohibiting a current deduction for certain capital expenditures. Treasury Regulations define "capital expenditures" as amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use. Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Treasury regulations provide that capital expenditures include the costs of acquiring or substantially improving buildings, machinery, equipment, furniture, fixtures and similar property having a useful life substantially beyond the current year. In *INDOPCO, Inc.* v. *Commissioner,* 112 S. Ct. 1039 (1992), the Supreme Court required the capitalization of legal fees incurred by a taxpayer in connection with a friendly takeover by one of its customers on the grounds that the merger would produce significant economic benefits to the taxpayer extending beyond the current year; capitalization of the costs thus would match the expenditures with the income produced. Similarly, the amount paid for the construction of a filtration plant, with a life extending beyond the year of completion, and as a permanent addition to the taxpayer's mill property, was a capital expenditure rather than an ordinary and necessary current business expense. *Woolrich Woolen Mills* v. *United States,* 289 F.2d 444 (3d Cir. 1961).

Although Treasury regulations provide that expenditures that materially increase the value of property must be capitalized, they do not set forth a method of determining how and when value has been increased. In *Plainfield-Union Water Co.* v. *Commissioner,* 39 T.C. 333 (1962), nonacq., 1964–2 C.B. 8, the U.S. Tax Court held that increased value was determined by comparing the value of an asset after the expenditure with its value before the condition necessitating the expenditure. The Tax Court stated that "an expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."

In several Technical Advice Memoranda (TAM), the Internal Revenue Service (IRS) declined to apply the *Plainfield Union* valuation analysis, indicating that the analysis represents just one of several alternative methods of determining increases in the value of an asset. In TAM 9240004 (June 29, 1992), the IRS required certain asbestos removal costs to be capitalized rather than expensed. In that instance, the taxpayer owned equipment that was manufactured with insulation containing asbestos; the taxpayer replaced the asbestos insulation with less thermally efficient, non-asbestos insulation. The IRS concluded that the expenditures resulted in a material increase in the value of the equipment because the asbestos removal eliminated human health risks, reduced the risk of liability to employees resulting from the contamination, and made the property more marketable. Similarly, in TAM 9411002 (November 19, 1993), the IRS required the capitalization of expenditures to remove and replace asbestos in connection with the conversion of a boiler room to garage and office space. However, the IRS permitted deduction of costs of encapsulating exposed asbestos in an adjacent warehouse.

In 1994, the IRS issued Rev. Rul. 94–38, 1994–1 C.B. 35, holding that soil remediation expenditures and ongoing water treatment expenditures incurred to clean up land and water that a taxpayer contaminated with hazardous waste are deductible. In this ruling, the IRS explicitly accepted the *Plainfield Union* valuation analysis.[64] However, the IRS also held that costs allocable to constructing a groundwater treatment facility are capital expenditures.

In 1995, the IRS issued TAM 9541005 (October 13, 1995) requiring a taxpayer to capitalize certain environmental study costs, as well as associated consulting and legal fees. The taxpayer acquired the land and conducted activities causing hazardous waste contamination. After the contamination, but before it was discovered, the company donated the land to the county to be developed into a recreational park. After the county discovered the contamination, it reconveyed the land to the company for $1. The company incurred the costs in developing a remediation strategy. The IRS held that the costs were not deductible under section 162 because the company acquired the land in a contaminated state when it pur-

[64] Rev. Rul. 94–38 generally rendered moot the holding in TAM 9315004 (December 17, 1992) requiring a taxpayer to capitalize certain costs associated with the remediation of soil contaminated with polychlorinated biphenyls (PCBs).

chased the land from the county. In January, 1996, the IRS revoked and superseded TAM 9541005 (PLR 9627002). Noting that the company's contamination of the land and liability for remediation were unchanged during the break in ownership by the county, the IRS concluded that the break in ownership should not, in and of itself, operate to disallow a deduction under section 162.

Reasons for Change

To encourage the cleanup of contaminated sites, as well as to eliminate uncertainty regarding the appropriate treatment of environmental remediation expenditures for Federal tax law purposes, the Committee believes that it is appropriate to provide clear and consistent rules regarding the Federal tax treatment of certain environmental remediation expenses.

Explanation of Provision

The bill provides that taxpayers could elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property which would otherwise be allocated to the site under the principles set forth in *Comm'r* v. *Idaho Power Co.*[65] and section 263A are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate State environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas would mean (1) empowerment zones and enterprise communities (as designated under present law and the D.C. Enterprise Zone designated under the bill); and (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots.

Both urban and rural sites qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) cannot be targeted areas. Appropriate State environmental agencies are designated by the EPA; if no State agency is designated, the EPA is responsible for providing the certification. Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, cer-

[65] *Comm'r* v. *Idaho Power Co.*, 418 U.S. 1 (1974) (holding that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under section 263(a)(1)).

tain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

The bill further provides that, in the case of property to which a qualified environmental remediation expenditure otherwise would have be capitalized, any deduction allowed under the bill would be treated as a depreciation deduction and the property would be treated as subject to section 1245. Thus, deductions for qualified environmental remediation expenditures would be subject to recapture as ordinary income upon sale or other disposition of the property.

Effective Date

The provision applies to eligible expenditures incurred after the date of enactment.

9. Combined employment tax reporting demonstration project (sec. 769 of the bill)

Present Law

Traditionally, Federal tax forms are filed with the Federal government and State tax forms are filed with individual states. This necessitates duplication of items common to both returns. Some States have recently been working with the IRS to implement combined State and Federal reporting of certain types of items on one form as a way of reducing the burdens on taxpayers. The State of Montana and the IRS have cooperatively developed a system to combine State and Federal employment tax reporting on one form. The one form would contain exclusively Federal data, exclusively State data, and information common to both: the taxpayer's name, address, TIN, and signature.

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Implementation of the combined Montana-Federal employment tax reporting project has been hindered because the IRS interprets section 6103 to apply that provision's restrictions on disclosure to information common to both the State and Federal portions of the combined form, although these restrictions would not apply to the State with respect to the State's use of State-requested information if that information were supplied separately to both the State and the IRS.

Reasons for Change

The Committee believes it is appropriate to permit a demonstration project to assess the feasibility and desirability of expanding combined reporting in the future.

Explanation of Provisions

The bill permits implementation of a demonstration project to assess the feasibility and desirability of expanding combined reporting in the future. There are several limitations on the demonstration project. First, it is limited to the State of Montana and the IRS. Second, it is limited to employment tax reporting. Third, it is limited to disclosure of the name, address, TIN, and signature of the taxpayer, which is information common to both the Montana and Federal portions of the combined form. Fourth, it is limited to a period of five years.

Effective Date

The provision is effective on the date of enactment, and will expire on the date five years after the date of enactment.

10. Qualified small-issue bonds (sec. 770 of the bill and sec. 144(a) of the Code)

Present Law

Interest on certain small issues of private activity bonds issued by State or local governments ("qualified small-issue bonds") is excluded from gross income if certain conditions are met. First, at least 95 percent of the bond proceeds must be used to finance manufacturing facilities or certain agricultural land or equipment. Second, the bond issue must have an aggregate face amount of $1 million or less, or alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, must not exceed $10 million. (The maximum face amount of bonds would not be increased over present-law amounts.)

Issuance of qualified small-issue bonds, like most other private activity bonds, is subject to annual State volume limitations and to other rules.

Reasons for Change

The Committee believes that the $10 million total capital expenditure limit has come to deny the benefits of tax-exempt bonds to certain projects that deserve them. At the same time, the Committee maintains its position that the maximum size of the tax-exempt bond issue for all eligible small-issue bond projects should be retained.

Explanation of Provision

The bill increases the maximum capital expenditure limit under present law from $10 million to $20 million. The maximum amount of bonds is not to be increased over present-law amounts.

Effective Date

The provision is effective for bonds issued after December 31, 1997.

11. Extend production credit for electricity produced from wind and "closed loop" biomass (sec. 771 of the bill and sec. 45 of the Code)

Present Law

An income tax credit is allowed for the production of electricity from either qualified wind energy or qualified "closed-loop" biomass facilities (sec. 45). The credit is equal to 1.5 cents (plus adjustments for inflation since 1992) per kilowatt hour of electricity produced from these qualified sources during the 10-year period after the facility is placed in service.

The credit applies to electricity produced by a qualified wind energy facility placed in service after December 31, 1993, and before July 1, 1999, and to electricity produced by a qualified closed-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999. Closed-loop biomass is the use of plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not apply to the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). It also does not apply to taxpayers who use standing timber to produce electricity. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party.

The credit for electricity produced from wind or closed-loop biomass is a component of the general business credit (sec. 38(b)(1)). This credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back 3 taxable years and carried forward 15 taxable years.

Reasons for Change

The Committee believes that the production of electricity from renewable sources should be encouraged, and that by extending the placed-in-service date, more entrepreneurs will have the opportunity to develop these renewable energy sources.

Explanation of Provision

The bill extends the income tax credit for electricity produced from wind and closed-loop biomass for two years. Thus, the credit is available for qualifying electricity produced from facilities placed in service before July 1, 2001. As under present law, the credit is allowable for a period of ten years after the facility is placed in service.

Effective Date

The provision is effective as of the date of enactment.

12. Suspension of net income property limitation for production from marginal wells (sec. 772 of the bill and sec. 613(a) of the Code)

Present Law

The Code permits taxpayers to recover their investments in oil and gas wells through depletion deductions (sec. 613A). In the case of certain properties, the deductions may be determined using the percentage depletion method. Among the limitations that apply in calculating percentage depletion deductions is a restriction that the amount deducted may not exceed 100 percent of the net income from that property in any year (sec. 613(a)).

Specific percentage depletion rules apply to oil and gas production from "marginal" properties. Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells.

Reasons for Change

The Committee believes that a suspension of the net income property limitation for marginal oil and gas production is appropriate if the price of oil falls to unexpectedly low levels, to prevent such wells from being plugged and potentially losing their production in the long run.

Explanation of Provision

The 100-percent-of-net-income property limitation does not apply for any taxable year beginning in a calendar year in which the annual average wellhead price per barrel for crude oil (within the meaning of section 29(d)(2)(C)) is below $14 per barrel.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

13. Purchasing of receivables by tax-exempt hospital cooperative service organizations (sec. 773 of the bill and sec. 501(e) of the Code)

Present Law

Section 501(e) provides that an organization organized on a cooperative basis by tax-exempt hospitals will itself be tax-exempt if the organization is operated solely to perform, on a centralized basis, one or more of certain enumerated services for its members.

These services are: data processing, purchasing (including the purchase of insurance on a group basis), warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel services. An organization does not qualify under section 501(e) if it performs services other than the enumerated services. (Treas. reg. sec. 1.501(e)(-1(c)).

Reasons for Change

The Committee believes that it is important to clarify that permissible billing and collection services that can be carried out by hospital cooperative services organizations under section 501(e) include the purchase of patron accounts receivable on a recourse basis.

Explanation of Provision

The bill clarifies that, for purposes of section 501(e), billing and collection services include the purchase of patron accounts receivable on a recourse basis. Thus, hospital cooperative service organizations are permitted to advance cash on the basis of member accounts receivable, provided that each member hospital retains the risk of non-payment with respect to its accounts receivable.

Effective Date

The provision is effective for taxable years beginning after December 31, 1996. No inference is intended with respect to taxable years prior to the effective date.

14. Treatment of bonds issued by the Federal Home Loan Bank Board under the Federal guarantee rules (sec. 774 of the bill and sec. 149 of the Code)

Present Law

Generally, interest on bonds which are Federally guaranteed do not qualify for tax-exemption for Federal income tax purposes. Certain exceptions are provided including otherwise qualifying bonds guaranteed by the Federal Housing Administration, the Veterans' Administration, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association.

Reasons for Change

The Committee believes that because of a unique set of circumstances it is appropriate for the Federal Home Loan Bank Board (FHLBB) to be given this treatment. This should facilitate the FHLBB in meeting its obligations under the Community Redevelopment Act in a manner not unlike that currently available to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

Explanation of Provision

Bonds guaranteed by the Federal Home Loan Bank Board are not treated as Federally guaranteed for purposes of the Federal guarantee prohibition generally applicable to tax-exempt bonds.

Effective Date

The provision is effective for bonds issued after the date of enactment.

15. Increased period of deduction of traveling expenses while working away from home on qualified construction projects (sec. 775 of the bill and sec. 162 of the Code)

Present Law

A taxpayer is allowed, subject to limitations, to deduct the ordinary and necessary expenses of carrying on a trade or business, including the trade or business of being an employee. Expenses of carrying on the trade or business of being an employee are miscellaneous itemized deductions, deductible only to the extent they exceed 2 percent of adjusted gross income.

Deductible expenses include travel expenses (including amounts expended for meals and lodging) while temporarily away from home in pursuit of a trade or business. In the absence of facts and circumstances indicating otherwise, a taxpayer is considered to be temporarily away from home if the period of employment away from home does not exceed one year. If the period of employment away from home exceeds one year, the taxpayer is considered to be on an indefinite or permanent work assignment, and travel expenses (including amounts expended for meals and lodging) are not deductible.

Reasons for Change

The Committee believes that construction workers on qualified projects, who by the nature of their jobs are required to be on site, should be subject to a more liberal standard in determining whether they are temporarily away from home.

Explanation of Provision

The bill provides that, in the absence of facts and circumstances indicating otherwise, taxpayers employed on qualified construction projects will be considered to be temporarily away from home if the period of their employment away from home does not exceed 18 months (24 months if the qualified construction project is in a remote location), rather than one year as under present law. A qualified construction project is one that is identifiable and that has a completion date that is reasonably expected to occur within five years of its starting date. A qualified construction project is considered to be in a remote location if it is located in an area which lacks adequate housing, educational, medical or other facilities necessary for families.

The revised standards established by the bill apply to taxpayers who continue to maintain a household, and therefore incur duplicative expenses, at their place of principal residence.

Effective Date

The provision is effective for amounts paid or incurred in taxable years beginning after December 31, 1997.

16. Charitable contribution deduction for certain expenses incurred in support of Native Alaskan subsistence whaling (sec. 776 of the bill and sec. 170 of the Code)

Present Law

In computing taxable income, individuals who do not elect the standard deduction may claim itemized deductions, including a deduction (subject to certain limitations) for charitable contributions or gifts made during the taxable year to a qualified charitable organization or governmental entity (sec. 170). Individuals who elect the standard deduction may not claim a deduction for charitable contributions made during the taxable year.

No charitable contribution deduction is allowed for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization, contributions to which are deductible, may constitute a deductible contribution (Treas. Reg. sec. 1.170A–1(g)). Specifically, section 170(j) provides that no charitable contribution deduction is allowed for traveling expenses (including amounts expended for meals and lodging) while away from home, whether paid directly or be reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.

Reasons for Change

The Committee believes that it is appropriate to provide a charitable contribution deduction up to $7,500 per year for certain expenses incurred by individuals engaging in sanctioned subsistence whaling activities.

Explanation of Provision

The bill allows individuals to claim a deduction under section 170 not exceeding $7,500 per taxable year for certain expenses incurred in carrying out sanctioned whaling activities. The deduction is available only to an individual who is recognized by the Alaska Eskimo Whaling Commission as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities. The deduction is available for reasonable and necessary expenses paid by the taxpayer during the taxable year for (1) the acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities, (2) the supplying of food for the crew and other provisions for carrying out such activities, and (3) storage and distribution of the catch from such activities.

For purposes of the provision, the term "sanctioned whaling activities" means subsistence bowhead whale hunting activities conducted pursuant to the management plan of the Alaska Eskimo

Whaling Commission. No inference is intended regarding the deductibility of any whaling expenses incurred in a taxable year ending before the date of enactment of the bill.

Effective Date

The provision is effective for taxable years ending after the date of enactment.

17. Modification of empowerment zone and enterprise community criteria in the event of future designations of additional zones and communities (sec. 777 of the bill and sec. 1392 of the Code)

Present Law

Pursuant to the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), the Secretaries of the Department of Housing and Urban Development (HUD) and the Department of Agriculture designated a total of nine empowerment zones and 95 enterprise communities on December 21, 1994. As required by law, six empowerment zones are located in urban areas (with aggregate population for the six designated urban empowerment zones limited to 750,000) and three empowerment zones are located in rural areas.[66] Of the enterprise communities, 65 are located in urban areas and 30 are located in rural areas (sec. 1391). Designated empowerment zones and enterprise communities were required to satisfy certain eligibility criteria, including specified population limitations (sec. 1392(a)(1)), geographic size limitations (sec. 1392(a)(3)), and poverty rate criteria for census tracts within the empowerment zone or enterprise community (sec. 1392(a)(4)) as determined by the most recent decennial census data available.

The following tax incentives are available for certain businesses located in empowerment zones: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the zone; (2) an additional $20,000 of section 179 expensing for "qualified zone property" placed in service by an "enterprise zone business" (accordingly, certain businesses operating in empowerment zones are allowed up to $38,500 of expensing for 1998); and (3) special tax-exempt financing for certain zone facilities.

The 95 enterprise communities are eligible for the special tax-exempt financing benefits but not the other tax incentives available in the nine empowerment zones. In addition to these tax incentives, OBRA 1993 provided that Federal grants would be made to designated empowerment zones and enterprise communities.

The tax incentives for empowerment zones and enterprise communities generally will be available during the period that the designation remains in effect, i.e., a 10-year period. Under present law, no additional empowerment zones or enterprise communities may be designated.

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

Reasons for Change

In view of the unique characteristics of the States of Alaska and Hawaii, and the economically depressed areas within those States, the Committee believes that the generally applicable criteria for empowerment zones and enterprise communities should be modified in the event that Congress decides to provide for additional designations of such zones or communities.

Explanation of Provision

The bill modifies the present-law empowerment zone and enterprise community designation criteria under section 1392 so that, in the event that additional empowerment zones or enterprise communities are authorized to be designated in the future, any zones or communities designated in the States of Alaska or Hawaii will not be subject to the general size limitations under section 1392(a)(3), nor will such zones or communities be subject to the general poverty-rate criteria under section 1392(a)(4). Instead, nominated areas in either State will be eligible for designation as an empowerment zone or enterprise community if, for each census tract or block group within such area, at least 20 percent of the families have incomes which are 50 percent or less of the Statewide median family income. Such zones and communities will be subject to the population limitations under present-law section 1392(a)(1).

Effective Date

The provision is effective on the date of enactment.

18. Deductibility of meals provided for the convenience of the employer (sec. 778 of the bill and sec. 132 of the Code)

Present Law

In general, subject to several exceptions, only 50 percent of business meal and entertainment expenses are allowed as a deduction (sec. 274(n)). Under one exception, the value of meals that are excludable from employees" incomes as a de minimis fringe benefit (sec. 132) are fully deductible by the employer.

In addition, the courts that have considered the issue have held that if meals are provided for the convenience of the employer pursuant to section 119 they are fully deductible (*Boyd Gaming Corp.* v. *Commissioner*[67] and *Gold Coast Hotel & Casino* v. *I.R.S.*[68]).

Reasons for Change

The Committee believes that it is consistent with the case law to provide for full deductibility of business meals that are excludible from employees' incomes because they are provided for the convenience of the employer.

[67]106 T.C. No. 19 (May 23, 1996).
[68]U.S.D.C. Nev. CV–5–94–1146–HDM(LRL) (September 26, 1996).

Explanation of Provision

The bill provides that meals that are excludable from employees" incomes because they are provided for the convenience of the employer pursuant to section 119 of the Code are excludable as a de minimis fringe benefit and therefore are fully deductible by the employer. No inference is intended as to whether such meals are fully deductible under present law.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

19. Clarification of standard to be used in determining tax status of retail securities brokers (sec. 779 of the bill)

Present Law

Under present law, whether a worker is an employee or independent contractor is generally determined under a common-law facts and circumstances test. An employer-employee relationship is generally found to exist if the service recipient has not only the right to control the result to be accomplished by the work, but also the means by which the result is to be accomplished. The Internal Revenue Service ("IRS") generally takes the position that the presence and extent of instructions is important in reaching a conclusion as to whether a business retains the right to direct and control the methods by which a worker performs a job, but that it is also important to consider the weight to be given those instructions if they are imposed by the business only in compliance with governmental or governing body regulations. The IRS training manual provides that if a business requires its workers to comply with rules established by a third party (e.g., municipal building codes related to construction), the fact that such rules are imposed should be given little weight in determining the worker's status.

Reasons for Change

Broker-dealers are required to supervise the activities of their affiliated registered representatives in order to comply with State and Federal investor protection laws. The Committee believes that compliance with duty-to-supervise requirements does not constitute evidence of control for purposes of the common-law test for determining worker classification.

Explanation of Provision

Under the bill, in determining the status of a registered representative of a broker-dealer for Federal tax purposes, no weight is to be given to instructions from the service recipient which are imposed only in compliance with governmental investor protection standards or investor protection standards imposed by a governing body pursuant to a delegation by a Federal or State agency. It is intended that the provision be interpreted to apply for all Federal tax purposes.

Effective Date

The provision is effective with respect to services performed after December 31, 1997. No inference is intended that the treatment under the proposal is not present law.

TITLE VIII. REVENUE-INCREASE PROVISIONS

A. Financial Products

1. Require recognition of gain on certain appreciated positions in personal property (sec. 801(a) of the bill and new sec. 1259 of the Code)

Present Law

In general, gain or loss is taken into account for tax purposes when realized. Gain or loss generally is realized with respect to a capital asset at the time the asset is sold, exchanged, or otherwise disposed of. Gain or loss is determined by comparing the amount realized with the adjusted basis of the particular property sold. In the case of corporate stock, the basis of shares purchased at different dates or different prices generally is determined by reference to the actual lot sold if it can be identified. Special rules under the Code can defer or accelerate recognition in certain situations.

The recognition of gain or loss is postponed for open transactions. For example, in the case of a "short sale" (i.e., when a taxpayer sells borrowed property such as stock and closes the sale by returning identical property to the lender), no gain or loss on the transaction is recognized until the closing of the borrowing.

Transactions designed to reduce or eliminate risk of loss on financial assets generally do not cause realization. For example, a taxpayer may lock in gain on securities by entering into a "short sale against the box," i.e., when the taxpayer owns securities that are the same as, or substantially identical to, the securities borrowed and sold short. The form of the transaction is respected for income tax purposes and gain on the substantially identical property is not recognized at the time of the short sale. Pursuant to rules that allow specific identification of securities delivered on a sale, the taxpayer can obtain open transaction treatment by identifying the borrowed securities as the securities delivered. When it is time to close out the borrowing, the taxpayer can choose to deliver either the securities held or newly-purchased securities. The Code provides rules only to prevent taxpayers from using short sales against the box to accelerate loss or to convert short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss (sec. 1233(b)).

Taxpayers also can lock in gain on certain property by entering into offsetting positions in the same or similar property. Under the straddle rules, when a taxpayer realizes a loss on one offsetting position in actively-traded personal property, the taxpayer generally can deduct this loss only to the extent the loss exceeds the unrecognized gain in the other positions in the straddle. In addition, rules similar to the short sale rules prevent taxpayers from changing the tax character of gains and losses recognized on the offsetting positions in a straddle (sec. 1092).

Taxpayers may engage in other arrangements, such as "futures contracts," "forward contracts," "equity swaps" and other "notional principal contracts" where the risk of loss and opportunity for gain with respect to property are shifted to another party (the "counterparty"). These arrangements do not result in the recognition of gain by the taxpayer.

The Code accelerates the recognition of gains and losses in certain cases. For example, taxpayers are required each year to mark to market certain regulated futures contracts, foreign currency contracts, non-equity options, and dealer equity options, and to take any capital gain or loss thereon into account as 40 percent short-term gain and 60 percent long-term gain (sec. 1256).

Reasons for Change

In general, a taxpayer cannot completely eliminate risk of loss (and opportunity for gain) with respect to property without disposing of the property in a taxable transaction. In recent years, however, several financial transactions have been developed or popularized which allow taxpayers to substantially reduce or eliminate their risk of loss (and opportunity for gain) without a taxable disposition. Like most taxable dispositions, many of these transactions also provide the taxpayer with cash or other property in return for the interest that the taxpayer has given up.

One of these transactions is the "short sale against the box." In such a transaction, a taxpayer borrows and sells shares identical to the shares the taxpayer holds. By holding two precisely offsetting positions, the taxpayer is insulated from economic fluctuations in the value of the stock. While the short against the box is in place, the taxpayer generally can borrow a substantial portion of the value of the appreciated long stock so that, economically, the transaction strongly resembles a sale of the long stock.

Other transactions that have been used by taxpayers to transfer risk of loss (and opportunity for gain) involve entering into notional principal contracts or futures or forward contracts to deliver the same stock. For example, a taxpayer holding appreciated stock may enter into an "equity swap" which requires the taxpayer to make payments equal to the dividends and any increase in the stock's value for a specified period, and entitles the taxpayer to receive payments equal to any depreciation in value. The terms of such swaps also frequently entitle the shareholder to receive payments during the swap period of a market rate of return (e.g., the Treasury-bill rate) on a notional principal amount equal to the value of the shareholder's appreciated stock, making the transaction strongly resemble a taxable exchange of the appreciated stock for an interest-bearing asset.

Explanation of Provision

General rule

The bill requires a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the constructive sale.

If the requirements for a constructive sale are met, the taxpayer would recognize gain in a constructive sale as if the position were sold at its fair market value on the date of the sale and immediately repurchased. Except as provided in Treasury regulations, a constructive sale would generally not be treated as a sale for other Code purposes. An appropriate adjustment in the basis of the appreciated financial position would be made in the amount of any gain realized on a constructive sale, and a new holding period of such position would begin as if the taxpayer had acquired the position on the date of the constructive sale.

A taxpayer is treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same property, (2) enters into an offsetting notional principal contract with respect to the same property, or (3) enters into a futures or forward contract to deliver the same property. A constructive sale under any part of the definition occurs if the two positions are in property that, although not the same, is substantially identical. In addition, in the case of an appreciated financial position that is a short sale, a notional principal contract or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same property as the underlying property for the position. Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

The positions of two related persons are treated as together resulting in a constructive sale if the relationship is one described in section 267 or section 707(b) and the transaction is entered into with a view toward avoiding the purposes of the provision.

Whether any part of the constructive sale definition is met by one or more appreciated financial positions and offsetting transactions generally will be determined as of the date the last of such positions or transactions is entered into. More than one appreciated financial position or more than one offsetting transaction can be aggregated to determine whether a constructive sale has occurred. For example, it is possible that no constructive sale would result if one appreciated financial position and one offsetting transaction were considered in isolation, but that a constructive sale would result if the appreciated financial position were considered in combination with two transactions. Where the standard for a constructive sale is met with respect to only a *pro rata* portion of a taxpayer's appreciated financial position (e.g., some, but not all, shares of stock), that portion would be treated as constructively sold under the provision. If there is a constructive sale of less than all of any type of property held by the taxpayer, the specific property deemed sold would be determined under the rules governing actual sales, after adjusting for previous constructive sales under the bill. Under the regulations to be issued by the Treasury, either a taxpayer's appreciated financial position or its offsetting transaction might in some circumstances be disaggregated on a non-*pro rata* basis for purposes of the constructive sale determination.

The bill provides an exception from constructive sale treatment for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into. This exception does not apply, however, where a transaction is closed during the last 60 days of the taxable year or within 30 days thereafter (the "90-day period") unless (1) the taxpayer holds the appreciated financial position to which the transaction relates (e.g., the stock where the offsetting transaction is a short sale) throughout the 60-day period beginning on the date the transaction is closed and (2) at no time during such 60-day period is the taxpayer's risk of loss reduced (under the principles of section 246(c)(4)) by holding positions with respect to substantially similar or related property. These requirements do not apply to a transaction that is closed during the 90-day period where a similar transaction is reopened during such period, so long as the reopened transaction is closed during the 90-day period and the requirements of the previous sentence are met after such closing.

A transaction that has resulted in a constructive sale of an appreciated financial position (e.g., a short sale) is not treated as resulting in a constructive sale of another appreciated financial position so long as the taxpayer holds the position which was treated as constructively sold. However, when that position is assigned, terminated or disposed of by the taxpayer, the taxpayer immediately thereafter is treated as entering into the transaction that resulted in the constructive sale (e.g., the short sale) if it remains open at that time. Thus, the transaction can cause a constructive sale of another appreciated financial position at any time thereafter. For example, assume a taxpayer holds two appreciated stock positions and one offsetting short sale, and the taxpayer identifies the short sale as offsetting one of the stock positions. If the taxpayer then sells the stock position that was identified, the identified short position would cause a constructive sale of the taxpayer's other stock position at that time.

Definitions

An appreciated financial position is defined as any position with respect to any stock, debt instrument, or partnership interest, if there would be gain upon a taxable disposition of the position for its fair market value. A "position" is defined as an interest, including a futures or forward contract, short sale, or option. An exception is provided for debt instruments that are not convertible and the interest on which is either fixed, payable at certain variable rates (Treas. reg. sec. 1.860G–1(a)(3)) or is based on certain interest payments on a pool of mortgages. Other debt instruments, including those identified as part of a hedging or straddle transaction, are appreciated financial positions.

A notional principal contract is treated as an offsetting notional principal contract, and thus, results in a constructive sale of an appreciated financial position, if it requires the holder of the appreciated financial position to pay (or provide a contractual credit for) all or substantially all of the investment yield and appreciation on the position for a specified period and also gives the holder a right to be reimbursed for (or receive credit for) all or substantially all of any decline in value of the position.

A forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery of a substantially fixed amount of property and a substantially fixed price. Thus, a forward contract providing for delivery of an amount of property, such as shares of stock, that is subject to significant variation under the contract terms does not result in a constructive sale.

A constructive sale does not include a transaction involving an appreciated financial position that is marked to market, including positions governed by section 475 (mark to market for securities dealers) or section 1256 (mark to market for futures contracts, options and currency contracts). Nor does a constructive sale include any contract for sale of an appreciated financial position which is not a "marketable security" (as defined in section 453(f)) if the contract settles within one year after the date it is entered into.

Treasury guidance

The bill provides regulatory authority to the Treasury to treat as constructive sales certain transactions that have substantially the same effect as those specified (i.e., short sales, offsetting notional principal contracts and futures or forward contracts to deliver the same or substantially similar property).

It is anticipated that the Treasury will use the provision's authority to treat as constructive sales other financial transactions that, like those specified in the provision, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position. Because this standard requires reduction of both risk of loss and opportunity for gain, it is intended that transactions that reduce only risk of loss or only opportunity for gain will not be covered. Thus, for example, it is not intended that a taxpayer who holds an appreciated financial position in stock will be treated as having made a constructive sale when the taxpayer enters into a put option with an exercise price equal to the current market price (an "at the money" option). Because such an option reduces only the taxpayer's risk of loss, and not its opportunity for gain, the above standard would not be met.

For purposes of the provision, it is not intended that risk of loss and opportunity for gain be considered separately. Thus, if a transaction has the effect of eliminating a *portion* of the taxpayer's risk of loss and a *portion* of the taxpayer's opportunity for gain with respect to an appreciated financial position which, taken together, are substantially all of the taxpayer's risk of loss and opportunity for gain, it is intended that Treasury regulations will treat this transaction as a constructive sale of the position.

It is anticipated that the Treasury regulations, when issued, will provide specific standards for determining whether several common transactions will be treated as constructive sales. One such transaction is a "collar." In a collar, a taxpayer commits to an option requiring him to sell a financial position at a fixed price (the "call strike price") and has the right to have his position purchased at a lower fixed price (the "put strike price"). For example, a shareholder may enter into a collar for a stock currently trading at $100 with a put strike price of $95 and a call strike price of $110. The effect of the transaction is that the seller has transferred the rights to all gain above the $110 call strike price and all loss below the $95 put strike price; the seller has retained all risk of loss and opportunity for gain in the range price between $95 and $110. A collar can be a single contract or can be effected by using a combination of put and call options.

In order to determine whether collars have substantially the same effect as the transactions specified in the provision, it is anticipated that Treasury regulations will provide specific standards that take into account various factors with respect to the appreciated financial position, including its volatility. Similarly, it is expected that several aspects of the collar transaction will be relevant, including the spread between the put and call prices, the period of the transaction, and the extent to which the taxpayer retains the right to periodic payments on the appreciated financial position (e.g., the dividends on collared stock). The Committee expects that the Treasury regulations with respect to collars will be applied prospectively, except in cases to prevent abuse.

Another common transaction for which a specific regulatory standard may be appropriate is a so-called "in-the-money" option, i.e., a put option where the strike price is significantly above the current market price or a call option where the strike price is significantly below the current market price. For example, if a shareholder purchases a put option exercisable at a future date (a so-called "European" option) with a strike price of $120 with respect to stock currently trading at $100, the shareholder has eliminated all risk of loss on the position for the option period and assured himself of all gain on the stock for any appreciation up to $120. In determining whether such a transaction will be treated as a constructive sale, it is anticipated that Treasury regulations will provide a specific standard that takes into account many of the factors described above with respect to collars, including the yield and volatility of the stock and the period and other terms of the option.

For collars, options and some other transactions, one approach that Treasury might take in issuing regulations is to rely on option prices and option pricing models. The price of an option represents the payment the market requires to eliminate risk of loss (for a put option) and to purchase the right to receive yield and gain (for a call option). Thus, option pricing offers one model for quantifying both the total risk of loss and opportunity for gain with respect to an appreciated financial position, as well as the proportions of these total amounts that the taxpayer has retained.

In addition to setting specific standards for treatment of these and other transactions, it may be appropriate for Treasury regulations to establish "safe harbor" rules for common financial transactions that do not result in constructive sale treatment. An example might be a collar with a sufficient spread between the put and call prices, a sufficiently limited period and other relevant terms such that, regardless of the particular characteristics of the stock, the collar probably would not transfer substantially all risk of loss and opportunity for gain.

Effective Date

The provision is effective for constructive sales entered into after June 8, 1997. A special rule is provided for transactions before this date which would have been constructive sales under the provision. The positions in such a transaction will not be taken into account in determining whether a constructive sale after June 8, 1997, has occurred, provided that the taxpayer identifies the offsetting positions of the earlier transaction within 30 days after the date of enactment. The special rule will cease to apply on the date the taxpayer ceases to hold any of the offsetting positions so identified.

In the case of a decedent dying after June 8, 1997, if (1) a constructive sale of an appreciated financial position (as defined in the provision) occurred before such date, (2) the transaction remains open for not less than two years, and (3) the transaction is not closed in a taxable transaction within 30 days after the date of enactment, such position (and any property related to it, under the principles of the provision) will be treated as property constituting rights to receive income in respect of a decedent under section 691.

2. Election of mark to market for securities traders and for traders and dealers in commodities (sec. 801(b) of the bill and new sec. 475(d) of the Code)

Present Law

A dealer in securities must compute its income pursuant to a mark-to-market method of accounting (sec. 475). Any security that is inventory must be included in inventory at its fair market value, and any security that is not inventory and that is held at year end is treated as sold for its fair market value. There is an exception to mark-to-market treatment for any security identified as held for investment or not held for sale to customers (or a hedge of such a security). For this purpose, a "dealer in securities" is a person who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For this purpose, "security" means any stock in a corporation; any partnership or beneficial ownership interest in a widely-held or publicly-traded partnership or trust; any note, bond, debenture, or other evidence of indebtedness; an interest rate, currency or equity notional principal contract; any evidence of an interest in, or a derivative financial instrument of any security described above; and certain positions identified as hedges of any of the above. Any gain or loss taken into account under these provisions generally is treated as ordinary gain or loss.

Traders in securities generally are taxpayers who engage in a trade or business involving active sales or exchanges of securities on the market, rather than to customers. The mark-to- market treatment applicable to securities dealers does not apply to traders in securities or to dealers in other property.

Reasons for Change

Mark-to-market accounting generally provides a clear reflection of income with respect to assets that are traded in established markets. For market-valued assets, mark-to-market accounting imposes few burdens and offers few opportunities for manipulation. Securities and exchange- traded commodities have determinable market values, and securities traders and commodities traders and dealers regularly calculate year-end values of their assets in determining their income for financial statement purposes. Many commodities dealers also utilize year-end values in adjusting their inventory using the lower-of-cost-or-market method for Federal income tax purposes.

Explanation of Provision

The bill allows securities traders and commodities traders and dealers to elect application of the mark-to-market accounting rules, which apply only to securities dealers under present law. All securities held by an electing taxpayer in connection with a trade or business as a securities trader, and all commodities held by an electing taxpayer in connection with a trade or business as a commodities dealer or trader, are subject to mark-to-market treatment. The taxpayer is allowed to identify property not held in connection with its trade or business as not subject to the election. As for securities dealers under present law, gain or loss recognized by an electing taxpayer under the provision is ordinary gain or loss.

With respect to a commodities dealer, all of the provisions of present law section 475 apply as if commodities were securities. Commodities for purposes of the provision would include only commodities of a kind customarily dealt in on an organized commodities exchange. It is anticipated that Treasury regulations will provide that section 475(c)(4), which prevents a dealer from treating certain notional principal contracts and other derivative financial instruments as held for investment, will apply only to contacts and instruments referenced to commodities in the case of a commodities dealer.

For securities traders, some of the provisions of present law section 475 apply, but others that are specific to dealers do not. For example, because a securities trader does not hold inventory, the mark-to-market rules for inventory are not applicable to traders. In addition, securities that are not held in connection with the trade or business of a securities trader are excluded from mark-to-market treatment if the trader identifies the securities in the trader's records before the close of the day on which they are acquired under rules similar to those of section 475(b)(2) for dealers. For purposes of the bill, a security that hedges another security that is held in connection with the trade or business would be treated as so held. The provisions applicable to securities traders apply to commodities traders as if commodities were securities.

The election is to be made separately with respect to the taxpayer's entire business as (1) a securities trader, (2) a commodities trader, or (3) a commodities dealer. Thus, a taxpayer that is both a commodities dealer and a securities trader may make the election with respect to one business, but not the other. The election will be made in the time and manner prescribed by the Secretary of the Treasury and will be effective for the taxable year for which it is made and all subsequent taxable years, unless revoked with the consent of the Secretary.

Effective Date

The provision applies to taxable years of traders or dealers ending after the date of enactment. For a taxpayer making the election, the adjustments required under section 481 as a result of the change in accounting method are required to be taken into account ratably over the four-year period beginning in the first taxable year for which the election is in effect.

For elections made for the first taxable year ending after the date of enactment, the taxpayer must identify the securities or commodities to which the election will apply within 30 days of the date of enactment.

3. Limitation on exception for investment companies under section 351 (sec. 802 of the bill and sec. 351(e) of the Code)

Present Law

A contribution of property to a corporation does not result in gain or loss to the contributing shareholder if the contributor is part of a group of contributors who own 80 percent of the voting stock of each class of stock entitled to vote. A contribution of property to a partnership generally does not result in recognition of gain or loss to the contributing partner.

Certain Code sections provide exceptions to the general rule for deferral of pre-contribution gain and loss. Gain or loss is recognized upon a contribution by a shareholder to a corporation that is an investment company (sec. 351(e)(1)). Gain, but not loss, is recognized upon a contribution by a partner to a partnership that would be treated as an investment company if the partnership were a corporation (sec. 721(b)). Under Treasury regulations, a contribution of property by a shareholder to a corporation, or by a partner to a partnership, is treated as a transfer to an investment company only if (1) the contribution results, directly or indirectly, in a diversification of the transferor's interests, and (2) the transferee is (a) a regulated investment company ("RIC"), (b) a real estate investment trust ("REIT"), or (c) a corporation more than 80 percent of the assets of which by value (excluding cash and non-convertible debt instruments) are readily marketable stocks or securities or interests in RICs or REITs that are held for investment (Treas. reg. sec. 1.351–1(c)(1)).

Reasons for Change

Under present law and regulations, a partnership or a corporation is not treated as an investment company even though more than 80 percent of its assets are a combination of readily marketable stock and securities and other high-quality investment assets of determinable values, such as non-convertible debt instruments, notional principal contracts, foreign currency and interests in metals. Thus, under present law, a partner may contribute stock, securities or other assets to an investment partnership, and a shareholder may contribute such assets to a corporation (e.g., a RIC) and, without current taxation, receive an interest in an entity that is essentially a pool of high-quality investment assets. Where, as a result of such a transaction, the partner or shareholder has diversified or otherwise changed the nature of the financial assets in which it has an interest, the transaction has the effect of a taxable exchange. Of particular concern to the Committee is the reappearance of so-called "swap funds," which are partnerships or RICs that are structured to fall outside the definition of an investment company, and thereby allow contributors to make tax-free contributions of stock and securities in exchange for an interest in an entity that holds similar assets.

Explanation of Provision

The bill modifies the definition of an investment company for purposes of determining whether a transfer of property to a partnership or corporation results in gain recognition (secs. 351(e) and 721(b)) by requiring that certain assets be taken into account for purposes of the definition, in addition to readily marketable stock and securities as under present law.

Under the bill, an investment company includes a RIC or REIT as under present law. In addition, under the bill, an investment company includes any corporation or partnership if more than 80 percent of its assets by value consist of money, stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts or derivatives, foreign currency, certain interests in precious metals, interests in REITs, RICs, common trust funds and publicly-traded partnerships or other interests in non-corporate entities that are convertible into or exchangeable for any of the assets listed. Other assets that count toward the 80-percent test are an interest in an entity substantially all of the assets of which are assets listed, and to the extent provided in Treasury regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to assets listed.[69] Finally, the bill grants regulatory authority to the Treasury to add other assets to the list set out in the provision, or, under certain circumstances, to remove items from the list.

The bill is intended to change only the types of assets considered in the definition of an investment company in the present Treasury regulations (Treas. reg. sec. 1.351–1(c)(1)(ii)) and not to override the other provisions of those regulations. For example, the bill does not override (1) the requirement that only assets held for investment are considered for purposes of the definition (Treas. reg. sec. 1.351–1(c)(3)), (2) the rule treating the assets of a subsidiary as owned proportionally by a parent owning 50 percent or more of its stock (Treas. reg. sec. 1.351–1(c)(4)), (3) the requirement that the investment company determination consider any plan with regard to an entity's assets in existence at the time of transfer (Treas. reg. sec. 1.351–1(c)(2)[70]), and (4) the requirement that a contribution of property to an investment company result in diversification in order for gain to be recognized (Treas. reg. sec. 1.351–1(c)(1)(i)).

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[69] Until such regulations are issued, it is intended that the Treasury regulations promulgated under the similar provisions of section 731(c)(2) generally will apply. Specifically, it is intended that an entity will meet the "substantially all" requirement if 90 percent or more of its assets are listed assets (Treas. reg. sec. 1.731–2(c)(3)(i)). Similarly, with respect to partnerships and other non-corporate entities, it is intended that, where 20 percent or more (but less than 90 percent) of the entity's assets consist of listed assets, a *pro rata* portion of the interest in the entity will be treated as a listed asset. (Treas. reg. sec. 1.731–2(c)(3)(ii))

[70] Although money is counted toward the 80-percent test under the bill, this provision in the regulations should have the effect that where money is contributed and, pursuant to a plan, assets not treated as stock or securities under the bill are either purchased or contributed by other parties, the investment company determination would be made only on the basis of the entity's assets after such events.

Effective Date

The provision applies to all transfers after June 8, 1997, in taxable years ending after such date. An exception is provided for transfers of a fixed amount of securities made pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter until the transfer.

4. Gains and losses from certain terminations with respect to property (sec. 803 of the bill and sec. 1234A of the Code)

Present Law

Treatment of gains and losses.—Gain from the "sale or other disposition" is the excess of the amount realized therefrom over its adjusted basis; loss is the excess of adjusted basis over the amount realized. The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset.[71] The U.S. Supreme Court has held that the term "sale or exchange" is a narrower term than "sale or other disposition." [72] Thus, it is possible from there to be a taxable income from the sale or other disposition of an asset without that gain being treated as a capital gain.

Treatment of capital gains and losses.—Long-term capital gains of individuals are subject to a maximum rate of tax of 28 percent.[73] Capital losses of individuals are allowed to the extent of capital gains or the lower of those gains or $3,000.

Long-term capital gains of corporations are subject to the same rate of tax as ordinary income.[74] Capital losses of corporations are allowed only to the extent of the corporation's capital gains; excess capital losses may be carried back to the 3 preceding years and carried forward for the succeeding years.

In the case of gains and losses from the sale or exchange of property used in a trade or business, net gains generally are treated as capital gain while net losses are treated as ordinary losses (sec. 1231).

Court decisions interpreting the "sale or exchange" requirement.—There has been a considerable amount of litigation dealing with whether modifications of legal relationships between taxpayers is to be treated as a "sale or exchange." For example, in *Douglass Fairbanks* v. *U.S.,* 306 U.S. 436 (1939), the U.S. Supreme Court held that gain realized on the redemption of bonds before their maturity is not entitled to capital gain treatment because the redemp-

[71] Code section 1221 defines a capital asset to mean property held by the taxpayer other than (1) property properly includible in inventory of the taxpayer or primarily held for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable and real property used in the taxpayer's trade of business, (3) a copyright, a literary musical; or artistic composition, letter or memorandum, or similar property that was created by the taxpayer (or whose basis is determined, in whole or in part, the basis of the creator, (4) accounts or notes receivable acquired in the ordinary course of the taxpayer's trade or business, and (5) a publication of the United States Government which was received from the Government other than by sale.

[72] *Helvering* v. *William Flaccus Oak Leather Co.,* 313 U.S. 247 (1941).

[73] See bill section 311, which provides an alternative tax rates on long-term capital gains of 10 percent or 20 percent for taxpayers otherwise marginal bracket is 15 percent or greater than 15 percent, respectively.

[74] See bill section 321, which provides an alternative tax rate of 30 percent on corporate capital gains on assets held lower than 5 years.

tion was not a "sale or exchange".[75] Several court decisions interpreted the "sale or exchange" requirement to mean that a disposition, that occurs as a result of a lapse, cancellation, or abandonment, is not a sale or exchange of a capital asset, but produces ordinary income or loss. For example, in *Commissioner* v. *Pittston Co.,* 252 F. 2d 344 (2d Cir), *cert. denied,* 357 U.S. 919 (1958), the taxpayer was treated as receiving ordinary income from amounts received for acquisition from the mine owner of a contract that the taxpayer had made with mine owner to buy all of the coal mined at a particular mine for a period of 10 years on the grounds that the payments were in lieu of subsequent profits that would have been taxed as ordinary income. Similarly, *Commissioner* v. *Starr Brothers,* 205 F. 2d 673 (1953), the Second Circuit held that a payment that a retail distributor received from a manufacturer in exchange for waiving a contract provision prohibiting the manufacturer from selling to the distributor's competition was not a sale or exchange. Likewise, in *General Artists Corp.* v. *Commissioner,* 205 F. 2d 360, *cert. denied* 346 U.S. 866 (1953), the Second Circuit held that amounts received by a booking agent for cancellation of a contract to be the exclusive agent of a singer was not a sale or exchange. In *National-Standard Company* v. *Commissioner,* 749 F. 2d 369, the Sixth Circuit held that a loss incurred the transfer of foreign currency to discharge the taxpayer's liability was an ordinary loss, since transfer was not a "sale or exchange" of that currency. More recently, in *Stoller* v. *Commissioner,* 994 F. 2d 855, 93–1 U.S.T.C. par. 50349 (1993), the Court of Appeals for the District of Columbia held, in a transaction that preceded the effective date of section 1234A, that losses incurred on the cancellation of forward contracts to buy and sell short-term Government securities that formed a straddle were ordinary because the cancellation of the contracts was not a "sale or exchange."

The U.S. Tax Court has held that the abandonment of property subject to non-recourse indebtedness is a "sale" and, therefore, any resulting loss is a capital loss. *Freeland* v. *Commissioner*, 74 T.C. 970 (1980); *Middleton* v. *Commissioner,* 77 T.C. 310 (1981), *aff'd per curiam* 693 F.2d 124 (11th Cir. 1982); and *Yarbro* v. *Commissioner* 45 T.C.M. 170, aff'd. 737 F.2d 479 (5th Cir. 1984), *cert. denied,* 105 S.Ct. 959.

Extinguishment treated as sale or exchange—The Internal Revenue Code contains provisions that deem certain transactions to be a sale or exchange and, therefore, any resulting gain or loss is to be treated as a capital gain or loss. These rules generally provide for "sale or exchange" treatment as a way of extending capital gain or loss treatment of those transactions. Under one special provision, gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to certain personal property are treated as gains or losses from the sale of a capital asset (sec. 1234A). Personal property subject to this rule is (1) personal property of a type which is actively trad-

[75] The result in this case was overturned by enactment in 1934 of the predecessor of present law sec. 1271(a), see below. See section 117 of the Revenue Act of 1934, 28 Stat. 680, 714–715.

ed[76] and which is, or would be on acquisition, a capital asset in the hands of the taxpayer (other than stock that is not part of straddle or of a corporation that is not formed or availed of to take positions which offset positions in personal property of its shareholders) and (2) a "section 1256 contract"[77] which is capital asset in the hands of the taxpayer.[78] Section 1234A does not apply to the retirement of a debt instrument.

Retirement of debt obligations treated as sale or exchange.—Amounts received on the retirement of any debt instrument are treated as amounts received in exchange therefor (sec. 1271(a)(1)). In addition, gain on the sale or exchange of a debt instrument with OID[79] generally is treated as ordinary income to the extent of its OID if there was an intention at the time of its issuance to call the debt instrument before maturity (sec. 1271(a)(2)). These rules do not apply to (1) debt issued by a natural person or (2) debt issued before July 2, 1982, by a noncorporate or nongovernment issuer. As a result of this exemption, the character of gain or loss realized on retirement of an obligation issued by a natural person under present law is governed by case law.

Reasons for Change

Extinguishment treated as sale or exchange.—In general, the Committee believes that present law is deficient since it (1) taxes similar economic transactions differently, (2) effectively provides some, but not all, taxpayers with an election, and (3) its lack of certainty makes the tax laws unnecessarily difficult to administer.

The Committee believes that some transactions, such as settlements of contracts to deliver a capital asset, are economically equivalent to a sale or exchange of such contracts since the value of any asset is the present value of the future income that such asset will produce. In addition, to the extent that present law treats modifications of property rights as not being a sale or ex-

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[76] Treasury Regulations generally define "actively traded" as any personal property for which there is an established financial market. In addition, those regulations provided that "notional principal contract constitutes personal property of a type that is actively traded if contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on an established financial market" and that "rights and obligations of a party to a notional principal contract are rights and obligations with respect to personal property and constitute an interest is personal property." Treas. Reg. sec. 1.092(d)–1(c).

[77] A "Section 1256 contract" means (1) any regulated futures contract, (2) foreign currency contract, (3) nonequity option, or (4) dealer equity option.

[78] The prsent law provisions (sec. 1234A) which treats cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property as a sale of a capital asset was added by Congress in 1981 when Congress adopted a number of provisions dealing with tax straddles. There are two components or "legs" to a straddle, where the value of one leg changes inversely with the value of the other leg. Without a special rule, taxpayers were able to "leg-out" of the loss leg of the straddle, while retaining the gain leg, resulting the creation of an ordinary loss. In 1981, Congress believed that the effective ability of taxpayer to elect the character of a gain or loss leg of a straddle was unwarranted and provided the present law rule that a cancellation, lapse, expiration or other termination of a right is a sale or exchange. However, since straddles were the focus the 1981 legislation, that legislation was limited to types of property which were the subject of straddles, i.e., personal property (other than stock) of a type which is actively traded whihc is, or would be on acquisition, a capital asset in the hands of the taxpayer. The provision subsequently was extended to section 1256 contracts.

[79] The issuer of a debt instrument with OID generally accrues and deducts the discount, as interest, over the life of the obligation even though the amount of such interest is not paid until the debt matures. The holder of such a debt instrument also generally incldues the OID in income as it accrues as intrest on an accrual basis. The mandatory inclusion of OID in income does not apply, among other exceptions, to debt obligations issued by natural persons before March 2, 1984, and loans of less than $10,000 between natural persons if such loan is not made in the ordinary course of business of the lender (secs. 1272(a)(2) (D) and (E)).

change, present law effectively provides, in many cases, taxpayers with an election to treat the transaction as giving rise to capital gain, subject to more favorable rates than ordinary income, or an ordinary loss that can offset higher-taxed ordinary income and not be subject to limitations on use of capital losses. The effect of an election can be achieved by selling the property right if the resulting transaction results in a gain or providing for the extinguishment of the property right if the resulting transaction results in a loss.

Courts have given different answers as to whether transactions which terminate contractual interests are treated as a "sale or exchange." This lack of uniformity has caused uncertainty to both taxpayers and the Internal Revenue Service in the administration of the tax laws.

Accordingly, the Committee bill treats the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer to all types of property as a "sale or exchange." A major effect of the Committee bill would be to remove the effective ability of a taxpayer to elect the character of gains and losses from certain transactions. Another significant effect of the Committee bill would be to reduce the uncertainty concerning the tax treatment of modifications of property rights.

Character of gain on retirement of debt obligations issued by natural persons.—Similar objections can be raised about the rule which exempts debt of natural persons from the deemed sale or exchange rule applicable to debt of other taxpayers. The Committee believes that the debt of natural persons and other taxpayers is sufficiently economically similar to be similarly taxed upon their retirement. Accordingly, the Committee believes that the exception to the deemed sale or exchange rule on retirement of debt of a natural person should be repealed.

Explanation of Provision

Extension of relinquishment rule to all types of property.—The bill extends to all types of property the rule which treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer.

By definition, the extension of the "sale or exchange rule" of present law section 1234A to all property will only affect property that is not personal property which is actively traded on an established exchange. Thus, the committee bill will apply to (1) interests in real property and (2) non-actively traded personal property. An example of the first type of property interest that will be affected by the committee bill is the tax treatment of amounts received to release a lessee from a requirement that the premise be restored on termination of the lease.[80] An example of the second type of property interest that is affected by the committee bill is the for-

[80] See *Billy Rose Diamond Horseshoe, Inc.* v. *Commissioner,* 448 F. 2d 549(1971), where the Second Circuit held that payments were not entitled to capital gain treatment because there was no sale or exchange. See also, *Sirbo Holdings, Inc. v. Commissioner,* 509 F.2d 1220 (2d Cir. 1975).

feiture of a down payment under a contract to purchase stock.[81] The committee bill does not affect whether a right is "property" or whether property is a "capital asset."

Character of gain or loss on retirement of debt obligations issued by natural persons.—The committee bill repeals the provision that exempts debt obligations issued by natural persons effective for obligations issued after June 8, 1997. In addition, the committee bill terminates the grandfather of debt issued before July 2, 1982, by noncorporations or nongovernments and by natural persons before June 9, 1997, from the rule which treats gain or loss realized on retirement of such debt as gain or loss realized on an exchange effective for obligations acquired after June 8, 1997, unless the acquirer's basis in the obligation is a carryover basis (i.e., the basis is determined soley by reference to the basis from whom the acquirer acquired the obligation). Thus, under the bill, gain or loss on the retirement of such debt will be capital gain or loss.

Effective Date

Extension of relinquishment rule to all types of property.—The extension of the extinguishment rule applies to terminations occurring more than 30 days after the date of enactment of the provision.

Character of gain or loss on retirement of debt obligations issued by natural persons, etc.—The provision is effective for dispositions after the date of enactment. Thus, any gain or loss occurring after the date of enactment on (1) an obligation of a natural person issued after June 8, 1997, or (2) an obligation issued by a natural person on or before that date to which section 1271(b) currently applies and which is acquired after that date other than in a carryover basis transaction will be treated as a gain or loss from the exchange of the obligation.

B. Corporate Organizations and Reorganizations

1. Require gain recognition for certain extraordinary dividends (sec. 811 of the bill and sec. 1059 of the Code)

Present Law

A corporate shareholder generally can deduct at least 70 percent of a dividend received from another corporation. This dividends received deduction is 80 percent if the corporate shareholder owns at least 20 percent of the distributing corporation and generally 100 percent if the shareholder owns at least 80 percent of the distributing corporation.

Section 1059 of the Code requires a corporate shareholder that receives an "extraordinary dividend" to reduce the basis of the stock with respect to which the dividend was received by the nontaxed portion of the dividend. Whether a dividend is "extraordinary" is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non pro rata redemption

[81] See *U.S. Freight Co.* v. *U.S.* F.2d 887 (Ct. Cl. 1970), holding that forfeiture was an ordinary loss.

or a partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain on the sale or disposition of such stock, but not until that time (sec. 1059(a)(2)). The reduction in basis for this purpose occurs immediately before any sale or disposition of the stock (sec. 1059(d)(1)(A)). The Treasury Department has general regulatory authority to carry out the purposes of the section.

Except as provided in regulations, the extraordinary dividend provisions do not apply to result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns, where the dividend is eliminated or excluded under the consolidated return regulations. Double inclusion of earnings and profits (i.e., from both the dividend and from gain on the disposition of stock with a reduced basis) also should generally be prevented.[82] Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.[83]

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend (sec. 302). A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. Section 302(b) also contains several specific tests (e.g., a substantial reduction computation and a termination test) to identify redemptions that are not essentially equivalent to dividends. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules of section 318, including the option attribution rules of section 318(a)(4). The rules relating to treatment of cash or other property received in a reorganization contain a similar reference (sec. 356(a)(2)).

Reasons for Change

Corporate taxpayers have attempted to dispose of stock of other corporations in transactions structured as redemptions, where the redeemed corporate shareholder apparently expects to take the position that the transactions are dividends that qualify for the dividends received deduction. Thus, the redeemed corporate shareholder attempts to exclude from income a substantial portion of the amount received. In some cases, it appears that the taxpayers' interpretations of the option attribution rules of section 318(a)(4) are important to the taxpayers' contentions that their interests in the distributing corporation are not meaningfully reduced, and are, therefore, dividends.[84] Some taxpayers may argue that certain op-

[82] See H. Rept. 99–841, II–166, 99th Cong. 2d Sess. (September 18, 1986).

[83] See Treas. reg. sec. 1.701–2(f), Example (2).

[84] For example, it has been reported that Seagram Corporation intends to take the position that the corporate dividends-received will eliminate tax on significant distributions received from DuPont Corporation in a redemption of almost all the DuPont stock held by Seagram, coupled with the issuance of certain rights to reacquire DuPont stock. (See, e.g., Landro and Shapiro, "Hollywood Shuffle," Wall Street Journal, pp. A1 and A11 (April 7, 1995); Sloan, "For Seagram and DuPont, a Tax Deal that No One Wants to Brandy About," Washington Post, p. D3 (April 11, 1995); Sheppard, "Can Seagram Bail Out of DuPont without Capital Gain Tax," Tax Notes Today, (April 10, 1995, 95 TNT 75–4).

tions have sufficient economic reality that they should be recognized as stock ownership for purposes of determining whether a taxpayer has substantially reduced its ownership.

Even in the absence of options, the present law rules dealing with extraordinary dividends may permit inappropriate deferral of gain recognition when the portion of the distribution that is excluded due to the dividends received deduction exceeds the basis of the stock with respect to which the extraordinary dividend is received.

Explanation of Provision

Under the bill, except as provided in regulations, a corporate shareholder recognizes gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the nontaxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership.[85]

In addition, the bill requires immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. The reduction in basis of stock would be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.

Reorganizations or other exchanges involving amounts that are treated as dividends under section 356 of the Code are treated as redemptions for purposes of applying the rules relating to redemptions under section 1059(e). For example, if a recapitalization or other transaction that involves a dividend under section 356 has the effect of a non pro rata redemption or is treated as a dividend due to options being counted as stock, the rules of section 1059 apply. Redemptions of shares, or other extraordinary dividends on shares, held by a partnership will be subject to section 1059 to the extent there are corporate partners (e.g., appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest will be required).

Under continuing section 1059(g) of present law, the Treasury Department is authorized to issue regulations where necessary to carry out the purposes and prevent the avoidance of the provision.

Effective Date

The provision generally is effective for distributions after May 3, 1995, unless made pursuant to the terms of a written binding contract in effect on May 3, 1995 and at all times thereafter before such distribution, or a tender offer outstanding on May 3, 1995.[86] However, in applying the new gain recognition rules to any distribution that is not a partial liquidation, a non pro rata redemption, or a redemption that is treated as a dividend by reason of op-

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[85] Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient earnings and profits, the rules applies to the portion treated as a dividend.

[86] Thus, for example, in the case of a distribution prior to the effective date, the provisions of present law would continue to apply, including the provisions of present-law sections 1059(a) and 1059(d)(1), requiring reduction in basis immediately before any sale or disposition of the stock, and requiring recognition of gain at the time of such sale or disposition.

tions, September 13, 1995 is substituted for May 3, 1995 in applying the transition rules.

No inference is intended regarding the tax treatment under present law of any transaction within the scope of the provision, including transactions utilizing options.

In addition, no inference is intended regarding the rules under present law (or in any case where the treatment is not specified in the provision) for determining the shares of stock with respect to which a dividend is received or that experience a basis reduction.

2. Require gain recognition on certain distributions of controlled corporation stock (sec. 812 of the bill and secs. 355, 351(c), and 368(a)(2)(H) of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) as if such property had been sold for its fair market value. The shareholders generally treat the receipt of property as a taxable event as well. Section 355 of the Internal Revenue Code provides an exception to this rule for certain "spin-off" type distributions of stock of a controlled corporation, provided that various requirements are met, including certain restrictions relating to acquisitions and dispositions of stock of the distributing corporation ("distributing") or the controlled corporation ("controlled") prior and subsequent to a distribution.

In cases where the form of the transaction involves a contribution of assets to the particular controlled corporation that is distributed in connection with the distribution, there are specific Code requirements that distributing corporation's shareholders own "control" of the distributed corporation immediately after the distribution. Control is defined for this purpose as 80 percent of the voting power of all classes of stock entitled to vote and 80 percent of each other class of stock. (secs. 368(a)(1)(D), 368(c), and 351(a) and (c)). In addition, it is a requirement for qualification of any section 355 distribution that the distributing corporation distribute control of the controlled corporation (defined by reference to the same 80-percent test).[87] Present law has the effect of imposing more restrictive requirements on certain types of acquisitions or other transfers following a distribution if the company involved is the controlled corporation rather than the distributing corporation.

Reasons for Change

The Committee believes that section 355 was intended to permit the tax-free division of existing business arrangements among existing shareholders. In cases in which it is intended that new

[87] If as controlled corporation is acquired after a distribution, an issue may arise whether the acquisition can be viewed under step-transaction concepts as having occurred before the distribution, with the result that the distributing corporation would not be viewed as having distributed the necessary 80 percent control. The Internal Revenue Service has indicated that it will not rule on requests for section 355 treatment in cases in which there have been negotiations agreements or arrangements with respect to transactions or events which, if consummated before the distribution, would result in the distribution of stock or securities of a corporation which is not "controlled" by the distributing corporation. Rev. Proc 96–39, 1996–33 I.R.B. 11; see also Rev. Rul. 96–30, 1996–1 C.B. 36; Rev. Rul. 70–225, 1970–1 C.B. 80.

shareholders will acquire ownership of a business in connection with a spin off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired.

The Committee also believes that the difference in treatment of certain transactions following a spin-off, depending upon whether the distributing or controlled corporation engages in the transaction, should be minimized.

The Committee also is concerned that spin-off transactions within a single corporate group can have the effect of avoiding other present law rules that create or recapture excess loss accounts in affiliated groups filing consolidated returns.[88]

Such intra-group distributions also can have the effect of permitting possibly inappropriate basis increases (or preventing basis decreases) following a distribution, due to the differences between the basis allocation rules that govern spin-offs and those that apply to other distributions. In the case of an affiliated group not filing a consolidated return, it is also possible that section 355 distributions could in effect permit similar inappropriate basis results.

Explanation of Provision

The bill adopts additional restrictions under section 355 on acquisitions and dispositions of the stock of the distributing or controlled corporation.

Under the bill, if either the controlled or distributing corporation is acquired pursuant to a plan or arrangement in existence on the date of distribution, gain is recognized by the other corporation as of the date of the distribution.

In the case of an acquisition of a controlled corporation, the amount of gain recognized by the distributing corporation is the amount of gain that the distributing corporation would have recognized had stock of the controlled corporation been sold for fair market value on the date of distribution. In the case of an acquisition of the distributing corporation, the amount of gain recognized by the controlled corporation is the amount of net gain that the distributing corporation would have recognized had it sold its assets for fair market value immediately after the distribution. This gain is treated as long-term capital gain. No adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain.

Whether a corporation is acquired is determined under rules similar to those of present law section 355(d), except that acquisitions would not be restricted to "purchase" transactions. Thus, an acquisition occurs if one or more persons acquire 50 percent or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan or arrangement. For example,

[88] Excess loss accounts in consolidation generally are created when a subsidiary corporation makes a distribution (or has a loss that is used by other members of the group) that exceeds the parent's basis in the stock of the subsidiary. In general, such excess loss accounts in consolidation are permitted to be deferred rather than causing immediate taxable gain. Nevertheless, they are recaptured when a subsidiary leaves the group or in certain other situations. However, such excess loss accounts are not recaptured in certain cases where there is an internal spin-off prior to the subsidiary leaving the group. See. Treas. reg. sec. 1.1502–19(g). In addition, an excess loss account may not be created at all in certain cases that are similar economically to a distribution that would reduce the stock basis of the distributing subsidiary corporation, if the distribution from the subsidiary is structured to meet the form of a section 355 distribution.

assume a corporation ("P") distributes the stock of its wholly owned subsidiary ("S") to its shareholders. If, pursuant to a plan or arrangement, 50 percent or more of the vote or value of either P or S is acquired by one or more persons, the bill proposal requires gain recognition by the corporation not acquired. Except as provided in Treasury regulations, if the assets of the distributing or controlled corporation are acquired by a successor in a merger or other transaction under section 368(a)(1) (A), (C) or (D) of the Code, the shareholders (immediately before the acquisition) of the corporation acquiring such assets are treated as acquiring stock in the corporation from which the assets were acquired. Under Treasury regulations, other asset transfers also could be subject to this rule. However, in any transaction, stock received directly or indirectly by former shareholders of distributing or controlled, in a successor or new controlling corporation of either, is not treated as acquired stock if it is attributable to such shareholders" stock in distributing or controlled that was not acquired as part of a plan or arrangement to acquire 50 percent or more of such successor or other corporation.

Acquisitions occurring within the four-year period beginning two years before the date of distribution are presumed to have occurred pursuant to a plan or arrangement. Taxpayers can avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution.

The bill does not apply to distributions that would otherwise be subject to section 355(d) of present law, which imposes corporate level tax on certain disqualified distributions.

The bill does not apply to a distribution pursuant to a title 11 or similar case.

The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the proposal, including regulations to provide for the application of the proposal in the case of multiple transactions.

Except as provided in Treasury regulations, in the case of distributions of stock within an affiliated group of corporations (as defined in section 1504(a)), section 355 does not apply to any distribution of the stock of one member of the group to another member if it is part of a transaction that results in an acquisition that would be taxable to either the distributing or the controlled corporation.

In addition, in the case of any distribution of stock of one member of an affiliated group of corporations to another member, the Secretary of the Treasury is authorized under section 358(c) to provide adjustments to the basis of any stock in a corporation which is a member of such group, to reflect appropriately the proper treatment of such distribution.

As one example, the Secretary of the Treasury may consider providing rules that require a carryover basis within the group for the stock of the distributed corporation (including a carryover of an excess loss account, if any, in a consolidated return) and that also provide a reduction in the basis of the stock of the distributing corporation to reflect the change in the value and basis of the distributing corporation's assets. The Treasury Department may determine that the aggregate stock basis of distributing and controlled after the distribution may be adjusted to an amount that is less than the aggregate basis of the stock of the distributing corporation before the distribution, to prevent inappropriate potential for artificial losses or diminishment of gain on disposition of any of the corporations involved in the spin off.

The bill also modifies certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of section 355. In such cases, under section 351 and modified section 368(a)(2)(H) with respect to certain reorganizations under section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50 percent interest in the vote and value of stock of the distributed corporation.

The bill does not change the present-law requirement under section 355 that the distributing corporation must distribute 80 percent of the voting power and 80 percent of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the bill regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80-percent control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80-percent controlled subsidiary, but generally would not impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

Effective Date

The bill is generally effective for distributions after April 16, 1997. However, the part of the bill providing a greater-than-50-percent control requirement immediately after certain section 351 and 368(a)(1)(D) distributions will be effective for transfers after the date of enactment.

The bill will not apply to a distribution after April 16, 1997 that is part of an acquisition that would otherwise cause gain recognition to the distributing or controlled corporation under the bill, if such acquisition is (1) made pursuant to a written agreement which was binding on April 16, 1997 and at all times thereafter; (2) described in a ruling request submitted to the Internal Revenue Service on or before such date; or (3) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission ("SEC") required solely by reason of the distribution or acquisition. Any written agreement, ruling request, or public announcement or SEC filing is not within the scope of these transition provisions unless it identifies the acquiror of the distributing corporation or of any controlled corporation, whichever is applicable.

The part of the bill providing a greater-than-50-percent control provision for certain transfers after the date of enactment will not apply if such transfer meets the requirements of (1), (2), or (3) of the preceding paragraph.

3. Reform tax treatment of certain corporate stock transfers (sec. 813 of the bill and secs. 304 and 1059 of the Code)

Present Law

Under section 304, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. In determining whether a transaction so recharacterized is treated as a sale or a dividend, reference is made to the changes in the selling corporation's ownership of stock in the issuing corporation (applying the constructive ownership rules of section 318(a) with modifications under section 304(c)). Sales proceeds received by a corporate transferor that are characterized as a dividend may qualify for the dividends received deduction under section 243, and such dividend may bring with it foreign tax credits under section 902. Section 304 does not apply to transfers of stock between members of a consolidated group.

Section 1059 applies to "extraordinary dividends," including certain redemption transactions treated as dividends qualifying for the dividends received deduction. If a redemption results in an extraordinary dividend, section 1059 generally requires the shareholder to reduce its basis in the stock of the redeeming corporation by the nontaxed portion of such dividend.

Reasons for Change

Section 304 is directed primarily at preventing a controlling shareholder from claiming basis recovery and capital gain treatment on transactions that result in a withdrawal of earnings from corporate solution. These concerns are most relevant where the shareholder is an individual. Different concerns may be present if the shareholder is a corporation, due in part to the availability of the dividends received deduction. A corporation often may prefer a transaction to be characterized as a dividend, as opposed to a sale or exchange. Accordingly, a corporation may intentionally seek to apply section 304 to a transaction which is in substance a sale or exchange. Corporations that are related for purposes of section 304 need not be 80-percent controlled by a common parent. The separate rules for corporations filing a consolidated return, that would generally reduce basis for untaxed dividends received, do not apply. Furthermore, in some situations where the selling corporation does not in fact own any stock of the acquiring corporation before or after the transaction (except by attribution), it is possible that current law may lead to inappropriate results.

As one example, in certain related-party sales the selling corporation may take the position that its basis in any shares of stock it may have retained (or possibly in any shares of the acquiring corporation that it may own) need not be reduced by the amount of its dividends received deduction. This could result in an inappropriate shifting of basis. The result can be artificial reduction of gain or creation of loss on disposition of any such retained shares.

As one example, assume that domestic corporation X owns 70 percent of the shares of domestic corporation S and all the shares of domestic corporation B. S owns all the shares of domestic corporation T with a basis of $100. Assume that corporation B has sufficient earnings and profits so that any distribution of property would be treated as a dividend. Assume that S sells all but one of its shares in T to B for $99, their fair market value. Under present law, the transfer is treated as a redemption of shares of B, which redemption is treated as dividend to S because, even though S in fact owns no shares of B, it is deemed to own all the shares of B before and after the transaction through attribution from X. Taxpayers may contend that the one share of T retained (worth $1) retains the entire original basis of $100. Although S has received $99 from B for its other shares of T, and has not paid full tax on that receipt due to the dividends received deduction, S may now attempt to claim a $99 loss on disposing of the remaining share of T.

In international cases, a U.S. corporation owned by a foreign corporation may inappropriately claim foreign tax credits from a section 304 transaction. For example, if a foreign-controlled domestic corporation sells the stock of a subsidiary to a foreign sister corporation, the domestic corporation may take the position that it is entitled to credit foreign taxes that were paid by the foreign sister corporation. See Rev. Rul. 92–86, 1992–2 C.B. 199; Rev. Rul. 91–5, 1991–1 C.B. 114. However, if the foreign sister corporation had actually distributed its earnings and profits to the common foreign parent, no foreign tax credits would have been available to the domestic corporation.

Explanation of Provision

Under the bill, to the extent that a section 304 transaction is treated as a distribution under section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. Thus, the acquiring corporation is treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. In addition, the bill amends section 1059 so that, if the section 304 transaction is treated as a dividend to which the dividends received deduction applies, the dividend is treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account under section 1059.

Under the bill, a special rule applies to section 304 transactions involving acquisitions by foreign corporations. The bill limits the earnings and profits of the acquiring foreign corporation that are taken into account in applying section 304. The earnings and profits of the acquiring foreign corporation to be taken into account will not exceed the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of sec, 951(b)) of such corporation, and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of section 1248(d) (relating to certain exclusions from earnings and profits) would apply. The Secretary of the Treasury is to prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

No inference is intended as to the treatment of any transaction under present law.

Effective Date

The provision is effective for distributions or acquisitions after June 8, 1997 except that the provision will not apply to any such distribution or acquisition (1) made pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

4. Modify holding period for dividends-received deduction (sec. 814 of the bill and sec. 246(c) of the Code)

Present Law

If an instrument issued by a U.S. corporation is classified for tax purposes as stock, a corporate holder of the instrument generally is entitled to a dividends received deduction for dividends received on that instrument. This deduction is 70 percent of dividends received if the recipient owns less than 20 percent (by vote and value) of stock of the payor. If the recipient owns more than 20 percent of the stock the deduction is increased to 80 percent. If the recipient owns more than 80 percent of the payor's stock, the deduction is further increased to 100 percent for qualifying dividends.

The dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46- or 91-day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest. The holding period must be satisfied only once, rather than with respect to each dividend received.

Reasons for Change

Under present law, dividend-paying stocks can be marketed to corporate investors with accompanying attempts to hedge or relieve the holder from risk for much of the holding period of the stock, after the initial holding period has been satisfied. In addition, because of the limited application of section 1059 of the Code requiring basis reduction, many investors whose basis includes a price paid with the expectation of a dividend may be able to sell the stock after the receipt of a dividend not subject to tax at an artificial loss, even though the holder may actually have been relieved of the risk of loss for much of the period it has held the stock.

The Committee believes that no deduction for a distribution on stock should be allowed when the owner of stock does not bear the risk of loss otherwise inherent in the ownership of an equity interest at a time proximate to the time the distribution is made.

Explanation of Provision

The bill provides that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend.

Effective Date

The provision is generally effective for dividends paid or accrued after the 30th day after the date of the enactment of the bill. However, the provision will not apply to dividends received within two years of the date of enactment if (1) the dividend is paid with respect to stock held on June 8, 1997, and all times thereafter until the dividend is received; (2) the stock is continuously subject to a position described in section 246(c)(4) on June 8, 1997, and all times thereafter until the dividend is received; and (3) such stock and related position is identified by the taxpayer within 30 days after enactment of this Act. A stock will not be considered to be continuously subject to a position if such position is sold, closed or otherwise terminated and is reestablished.

C. Other Corporate Provisions

1. Registration of confidential corporate tax shelters and substantial understatement penalty (sec. 821 of the bill and secs. 6111 and 6662 of the Code)

Present Law

Tax shelter registration

An organizer of a tax shelter is required to register the shelter with the Internal Revenue Service (IRS) (sec. 6111). If the principal organizer does not do so, the duty may fall upon any other participant in the organization of the shelter or any person participating in its sale or management. The shelter's identification number must be furnished to each investor who purchases or acquires an interest in the shelter. Failure to furnish this number to the tax shelter investors will subject the organizer to a $100 penalty for each such failure (sec. 6707(b)).

A penalty may be imposed against an organizer who fails without reasonable cause to timely register the shelter or who provides false or incomplete information with respect to it. The penalty is the greater of one percent of the aggregate amount invested in the shelter or $500. Any person claiming any tax benefit with respect to a shelter must report its registration number on her return. Failure to do so without reasonable cause will subject that person to a $250 penalty (sec. 6707(b)(2)).

A person who organizes or sells an interest in a tax shelter subject to the registration rule or in any other potentially abusive plan or arrangement must maintain a list of the investors (sec. 6112).

A $50 penalty may be assessed for each name omitted from the list. The maximum penalty per year is $100,000 (sec. 6708).

For this purpose, a tax shelter is defined as any investment that meets two requirements. First, the investment must be (1) required to be registered under a Federal or state law regulating securities, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or state agency regulating the offering or sale of securities, or (3) a substantial investment. Second, it must be reasonable to infer that the ratio of deductions and 350 percent of credits to investment for any investor (i.e., the tax shelter ratio) may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale. An investment that meets these requirements will be considered a tax shelter regardless of whether it is marketed or customarily designated as a tax shelter (sec. 6111(c)(1)).

Accuracy-related penalty

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement.

The substantial understatement penalty applies in the following manner. If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there was a reasonable basis for the tax treatment of the item. Special rules apply to tax shelters.

With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. The reduction in the understatement for items disclosed on the return is inapplicable to both corporate and non-corporate tax shelters. For this purpose, a tax shelter is a partnership or other entity, plan, or arrangement the principal purpose of which is the avoidance or evasion of Federal income tax.

The Secretary may waive the penalty with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

Reasons for Change

The provision will improve compliance with the tax laws by giving the Treasury Department earlier notification than it generally receives under present law of transactions that may not comport with the tax laws. In addition, the provision will improve compliance by discouraging taxpayers from entering into questionable transactions. Also, the provision will improve economic efficiency, because investments that are not economically motivated, but that are instead tax-motivated, may reduce the supply of capital available for economically motivated activities, which could cause a loss of economic efficiency.

Explanation of Provision

Tax shelter registration

The provision requires a promoter of a corporate tax shelter to register the shelter with the Secretary. Registration is required not later than the next business day after the day when the tax shelter is first offered to potential users. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant is required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

A corporate tax shelter is any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of $100,000.

A transaction is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The promoter includes specified related parties.

Registration will require the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters are required to maintain lists of those who have signed confidentiality agreements, or otherwise have been subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters must retain lists of those paying fees with respect to plans or arrangements that have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations will be treated as taxpayer information under the provisions of section 6103 and will therefore not be subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments with respect to offerings after late registration). A similar penalty is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50-percent penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50-percent penalty to 75 percent of the applicable fees.

Substantial understatement penalty

The provision makes two modifications to the substantial understatement penalty. The first modification affects the reduction in the amount of the understatement which is attributable to an item if there is a reasonable basis for the treatment of the item. The provision provides that in no event would a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation. No inference is intended that such a multi-party financing transaction could not also be a tax shelter as defined under the modification described below or under present law.

The second modification affects the special tax shelter rules, which define a tax shelter as an entity the principal purpose of which is the avoidance or evasion of Federal income tax. The provision instead provides that a significant purpose (rather than the principal purpose) of the entity must be the avoidance or evasion of Federal income tax for the entity to be considered a tax shelter. This modification conforms the definition of tax shelter for purposes of the substantial understatement penalty to the definition of tax shelter for purposes of these new confidential corporate tax shelter registration requirements.

Treasury report

The provision also directs the Treasury Department, in consultation with the Department of Justice, to issue a report to the tax-writing committees on the following tax shelter issues: (1) a description of enforcement efforts under section 7408 of the Code (relating to actions to enjoin promoters of abusive tax shelters) with respect to corporate tax shelters and the lawyers, accountants, and others who provide opinions (whether or not directly addressed to the taxpayer) regarding aspects of corporate tax shelters; (2) an evaluation of whether the penalties regarding corporate tax shelters are generally sufficient; and (3) an evaluation of whether confidential tax shelter registration should be extended to transactions where the investor (or potential investor) is not a corporation. The report is due one year after the date of enactment.

Effective Date

The tax shelter registration provision applies to any tax shelter offered to potential participants after the date the Treasury Department issues guidance with respect to the filing requirements. The modifications to the substantial understatement penalty apply to items with respect to transactions entered into after the date of enactment.

2. Treat certain preferred stock as "boot" (sec. 822 of the bill and secs. 351, 354, 355, 356 and 1036 of the Code)

Present Law

In reorganization transactions within the meaning of section 368 and certain other retructurings, no gain or loss is recognized except to the extent "other property" (often called "boot") is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock can be received tax-free in a reorganization. Upon the receipt of "other property," gain but not loss can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this debt-for-debt rule, similar rules generally apply to transactions described in section 351.

Reasons for Change

Certain preferred stocks have been widely used in corporate transactions to afford taxpayers non-recognition treatment, even though the taxpayer may receive relatively secure instruments in exchange for relatively risky instruments.

As one example, a shareholder of a corporation that is to be acquired for cash may not wish to recognize gain on a sale of his or her stock at that time. Transactions are structured so that a new holding company is formed, to which the shareholder contributes common stock of the company to be acquired, and receives in exchange preferred stock. The acquiring corporation contributes cash to a holding company, which uses the cash to acquire the stock of the other shareholders. Similar results might also be obtained if the corporation to be acquired recapitalized by issuing the preferred stock in exchange for the common stock of the shareholder. Features such as puts and calls may effectively determine the period within which total payment is to occur. In the case of an individual shareholder, the preferred stock may be puttable or redeemable only at death, in which case the shareholder obtains a basis step-up and never recognizes gain on the transaction.

Similarly, as another type of example, so called "auction rate" preferred stock has a mechanism to reset the dividend rate on preferred stock so that it tracks changes in interest rates over the term of the instrument, thus diminishing any risk that the "principal" amount of stock would change if interest rates changed.

The Committee believes that when such preferred stock instruments are received in certain exchange transactions, it is appropriate to view such instruments as taxable consideration since the investor has often obtained a more secure form of investment.

Explanation of Provision

The bill amends the relevant provisions (secs. 351, 354, 355, 356 and 1036) to treat certain preferred stock as "other property" (i.e., "boot") subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either section 351, 355, 368, or 1036, gain but not loss is recognized.

The bill applies to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate, including through a conversion privilege, in corporate growth to any significant extent), where (1) the holder has the right to require the issuer or a related person (within the meaning of secs. 267(b) and 707(b)) to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, the rules of (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. In addition, if neither the stock surrendered nor the stock received in the exchange is stock of a corporation any class of stock of which (or of a related corporation) is publicly traded, a right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder. Also, a right or obligation is disregarded in the case of stock transferred in connection with the performance of services if it may be exercised only upon the holder's separation from service.

The following exchanges are excluded from this gain recognition: (1) certain exchanges of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) certain exchanges of debt securities for preferred stock of the same or lesser value; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation is defined as any corporation if at least 50 percent of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50 percent of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family are defined by reference to the definition in section 447(e). Thus, a family includes children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock of the corporation. Shares held by a family member are treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the share, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of section 2701 for estate and gift tax consequences continue to apply.

An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment under section 354, but not section 351. In cases in which both sections 354 and 351 may apply to a transaction, section 354 generally will apply for purposes of this proposal. Thus, in that situation, the exchange would be tax free.

The Treasury Secretary has regulatory authority to (1) apply installment sale-type rules to preferred stock that is subject to this proposal in appropriate cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., secs. 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code.

Effective Date

The provision is effective for transactions after June 8, 1997, but will not apply to such transactions (1) made pursuant to a written agreement which was binding on such date and at all times thereafter, (2) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (3) described in a public announcement or filing with the Securities and Exchange Commission on or before such date.

D. Administrative Provisions

1. Information reporting on persons receiving contract payments from certain Federal agencies (sec. 831 of the bill and sec. 6041A of the Code)

Present Law

A service recipient (i.e., a person for whom services are performed) engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the IRS an information return reporting such payments (and the name, address, and taxpayer identification number of the recipient) if the remuneration paid to the person during the calendar year is $600 or more (sec. 6041A(a)). A similar statement must also be furnished to the person to whom such payments were made (sec. 6041A(e)). Treasury regulations explicitly exempt from this reporting requirement payments made to a corporation (Treas. reg. sec. 1.6041A–1(d)(2)).

The head of each Federal executive agency must file an information return indicating the name, address, and taxpayer identification number (TIN) of each person (including corporations) with which the agency enters into a contract (sec. 6050M). The Secretary of the Treasury has the authority to require that the returns be in such form and be made at such time as is necessary to make the returns useful as a source of information for collection purposes. The Secretary is given the authority both to establish minimum amounts for which no reporting is necessary as well as to extend the reporting requirements to Federal license grantors and subcontractors of Federal contracts. Treasury regulations provide that no reporting is required if the contract is for $25,000 or less (Treas. reg. sec. 1.6050M-1(c)(1)(i)).

Reasons for Change

Lowering the information reporting threshold from $25,000 to $600 will improve compliance because additional, small-dollar value contracts will be reported.

Explanation of Provision

The provision requires reporting of all payments of $600 or more made by a Federal executive agency to any person (including a corporation) for services. In addition, the provision requires that a copy of the information return be sent by the Federal agency to the recipient of the payment. An exception is provided for certain classified or confidential contracts.

Effective Date

The provision is effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

2. Disclosure of tax return information for administration of certain veterans programs (sec. 832 of the bill and sec. 6103 of the Code)

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service ("IRS") to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs ("DVA") of self-employment tax information and certain tax information supplied to the Internal Revenue Service and Social Security Administration by third parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension, health care, and other programs (sec. 6103(1)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA.

The DVA is required to comply with the safeguards currently contained in the Code and in section 1137(c) of the Social Security

Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

The DVA disclosure provision is scheduled to expire after September 30, 1998.

Reasons for Change

It is appropriate to permit disclosure of otherwise confidential tax information to ensure the correctness of government benefits payments.

Explanation of Provision

The provision permanently extends the DVA disclosure provision.

Effective Date

The provision is effective on the date of enactment.

3. Consistency rule for beneficiaries of trusts and estates (sec. 833 of the bill and sec. 6034A of the Code)

Present Law

An S corporation is required to file a return for the taxable year and is required to furnish to its shareholders a copy of certain information shown on such return. The shareholder is required to file its return in a manner that is consistent with the information received from the S corporation, unless the shareholder files with the Secretary of the Treasury a notification of inconsistent treatment (sec. 6037(c)). Similar rules apply in the case of partnerships and their partners (sec. 6222).

The fiduciary of an estate or trust that is required to file a return for any taxable year is required to furnish to beneficiaries certain information shown on such return (generally via a Schedule K-1) (sec. 6034A). In addition, a U.S. person that is treated as the owner of any portion of a foreign trust is required to ensure that the trust files a return for the taxable year and furnishes certain required information to each U.S. person who is treated as an owner of a portion of the trust or who receives any distribution from the trust (sec. 6048(b)). However, rules comparable to the consistency rules that apply to S corporation shareholders and partners in partnerships are not specified in the case of beneficiaries of estates and trusts.

Reasons for Change

Both partners in partnerships and shareholders of S corporations are required either to file their returns on a basis that is consistent with the information received from the partnership or S corporation or to identify any inconsistent treatment. The Committee believes that it is appropriate to apply such requirement also to beneficiaries of estates and trusts.

Explanation of Provision

Under the bill, a beneficiary of an estate or trust is required to file its return in a manner that is consistent with the information received from the estate or trust, unless the beneficiary files with its return a notification of inconsistent treatment identifying the inconsistency.

Effective Date

The provision is effective for returns filed after date of enactment.

4. Establish IRS continuous levy and improve debt collection (secs. 834, 835, and 836 of the bill and secs. 6331 and 6334 of the Code)

a. Continuous levy

Present Law

If any person is liable for any internal revenue tax and does not pay it within 10 days after notice and demand [89] by the IRS, the IRS may then collect the tax by levy upon all property and rights to property belonging to the person,[90] unless there is an explicit statutory restriction on doing so. A levy is the seizure of the person's property or rights to property. Property that is not cash is sold pursuant to statutory requirements.[91]

In general, a levy does not apply to property acquired after the date of the levy,[92] regardless of whether the property is held by the taxpayer or by a third party (such as a bank) on behalf of a taxpayer. Successive seizures may be necessary if the initial seizure is insufficient to satisfy the liability.[93] The only exception to this rule is for salary and wages.[94] A levy on salary and wages is continuous from the date it is first made until the date it is fully paid or becomes unenforceable.

A minimum exemption is provided for salary and wages.[95] It is computed on a weekly basis by adding the value of the standard deduction plus the aggregate value of personal exemptions to which the taxpayer is entitled, divided by 52.[96] For a family of four for taxable year 1996, the weekly minimum exemption is $325.[97]

Reasons for Change

The extension of the continuous levy provisions will substantially ease the administrative burdens of collecting taxes by levy. The Committee anticipates that taxpayers who already comply with the

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[89] Notice and demand is the notice give to a person liable for tax stating that the tax has been assessed and demanding that payment be made. The notice and demand must be mailed to the person's last known address or left at the person's dwelling or usual place of business (Code sec. 6303).

[90] Code sec. 6331.

[91] Code secs. 6335–6343.

[92] Code sec. 6331(b).

[93] Code sec. 6331(c).

[94] Code sec. 6331(e).

[95] Code sec. 6334(a)(9).

[96] Code sec. 6334(d)

[97] Standard deduction of $6,700 plus four personal exemptions at $2,550 each equals $16,900, which when divided by 52 equals $325.

tax laws will have a positive view of increased collections of taxes owed by taxpayers who have not complied with the tax laws.

Explanation of Provision

The provision amends the Code to provide that a continuous levy is also applicable to non-means tested recurring Federal payments. This is defined as a Federal payment for which eligibility is not based on the income and/or assets of a payee. For example, Social Security payments, which are subject to levy under present law, would become subject to continuous levy.

In addition, the provision provides that this levy would attach up to 15 percent of any specified payment due the taxpayer. This rule explicitly replaces the other specifically enumerated exemptions from levy in the Code. A continuous levy of up to 15 percent would also apply to unemployment benefits and means-tested public assistance.

The bill also permits the disclosure of otherwise confidential tax return information to the Treasury Department's Financial Management Service only for the purpose of, and to the extent necessary in, implementing these levy provisions.

Effective Date

The provision is effective for levies issued after the date of enactment.

b. Modifications of levy exemptions

Present Law

The Code exempts from levy workmen's compensation payments,[98] unemployment benefits[99] and means-tested public assistance.[100]

Reasons for Change

The Committee believes that if wages are subject to levy, wage replacement payments should also be subject to levy.

Explanation of Provision

The provision provides that the following property is not exempt from continuous levy if the Secretary of the Treasury (or his delegate) approves the levy of such property:

(1) workmen's compensation payments,
(2) unemployment benefits, and
(3) means-tested public assistance.

Effective Date

The provision applies to levies issued after the date of enactment.

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[98] Code sec. 6334(a)(7).
[99] Sec. 6334(a)(4).
[100] Sec 6334(a)(11).

E. Excise Tax Provisions

1. Extension and modification of Airport and Airway Trust Fund excise taxes (sec. 841 of the bill and secs. 4081, 4091, and 4261 of the Code)

Present Law

Present law imposes a variety of excise taxes on air transportation to finance the Airport and Airway Trust Fund programs administered by the Federal Aviation Administration (the "FAA"). In general, the full cost of FAA capital programs is financed from the Airport and Airway Trust Fund, while only a portion of FAA operational expenses is Trust Fund-financed. Overall, the portion of total FAA expenditures that has been financed from the Trust Fund has declined from 75 percent through the early 1990s to 62 percent for the 1997 fiscal year. The balance is financed by general taxpayers, rather than directly by program users. Each of the Airport and Airway Trust Fund excise taxes is scheduled to expire after September 30, 1997.

Commercial air passenger transportation taxes

Domestic air passenger transportation is subject to an *ad valorem* excise tax equal to 10 percent of the amount paid for the transportation. Taxable domestic air transportation includes both travel within the United States and certain travel between the United States and points in Canada or Mexico that are within 225 miles of the U.S. border (the "225-mile zone").

Special rules apply to air transportation between the continental United States and Alaska or Hawaii and between Alaska and Hawaii. The portion of such transportation which is not within the United States (e.g., the portion over the Pacific Ocean between the continental West Coast and Hawaii) is not subject to the 10-percent air passenger excise tax.[101] The 10-percent excise tax applies in full, however, to air transportation within the States of Alaska and Hawaii.

The 10-percent air passenger transportation excise tax also does not apply to domestic U.S. segments of uninterrupted international air transportation. Uninterrupted international air transportation includes only travel (entirely by air) that does not both begin and end in the United States (or in the 225-mile zone) and during which there is no more than a 12-hour scheduled period between arrival and departure at any intermediate point in the United States. For example, assume that a passenger travels from New York to Tokyo, with a four-hour stop and aircraft change in Seattle. The domestic segment of the flight (i.e., New York to Seattle) is not subject to the domestic air passenger transportation excise tax because that segment is a part of uninterrupted international air transportation.

International air passenger transportation is subject to a $6 departure excise tax imposed on passengers departing the United States for other countries. No tax is imposed on passengers arriv-

[101] The $6 per passenger international departure excise tax, described below, does apply to this transportation.

ing in the United States from other countries. As with passengers departing the United States, separate domestic flights of arriving passengers that connect from international flights are exempt from tax, provided that stopover time at any point within the United States does not exceed 12 hours.

Because both the domestic and international air passenger excise taxes are imposed only on transportation for which an amount is paid, no tax is imposed on "free" travel (e.g., frequent flyer travel and airline industry employee travel for which the passenger is not directly charged).

The air passenger transportation excise taxes are imposed on passengers; transportation providers (generally airlines) are responsible for collecting and remitting the taxes to the Federal Government. In general, both the domestic and international air passenger transportation excise taxes are imposed without regard to whether the transportation is purchased within the United States. An exception provides that travel between the United States and the 225-mile zone is subject to the *ad valorem* domestic tax only if it is purchased within the United States.

The amount of air passenger transportation excise tax collected from a passenger must be stated separately on the ticket.

Commercial air cargo transportation

Domestic air cargo transportation is subject to a 6.25-percent *ad valorem* excise tax. This tax, like the air passenger excise taxes, is imposed on the consumer, with the transportation provider being required to collect and remit the tax to the Federal Government. However, there is no requirement that the tax be stated separately on shipping invoices.

Noncommercial aviation

Noncommercial aviation, or transportation on private aircraft which is not "for hire," is subject to excise taxes imposed on fuel in lieu of the commercial air passenger ticket and air cargo excise taxes. The current Airport and Airway Trust Fund tax rates on these fuels are 15 cents per gallon on aviation gasoline and 17.5 cents per gallon on jet fuel.

The aviation gasoline excise tax is imposed on removal of the fuel from a registered terminal facility (the same point as the highway gasoline excise tax). The jet fuel excise tax is imposed on sale of the fuel by a wholesale distributor. Many larger airports have dedicated pipeline facilities that directly service aircraft; in such a case, the tax effectively is imposed at the retail level. The person removing the gasoline from a terminal facility or the wholesale distributor of the jet fuel is liable for these taxes.

Deposit of air transportation excise taxes

Under present law, the air passenger ticket and freight excise taxes are collected from passengers and freight shippers by the commercial air carriers. The air carriers then remit the funds to the Treasury Department; however, the air carriers are not required to remit monies immediately. Excise tax returns are filed quarterly (similar to annual income tax returns), with taxes being deposited on a semi-monthly basis (similar to estimated income taxes). For air transportation sold during a semi-monthly period, air carriers may elect to treat the taxes as collected on the last day of the first week of the second following semi-monthly period. Under these "deemed collected" rules, for example, the taxes on air transportation sold between August 1 and August 15, are treated as collected by the air carriers on or before September 7, with the amounts generally being deposited with the Treasury Department by September 10. A special rule requires certain amounts deemed collected during the second half of September to be deposited by September 29.

Semi-monthly deposits and quarterly excise tax returns also are required with respect to the fuels excise taxes imposed on air transportation.

Overflight user fees

Non-tax user fees are imposed on air transportation (both commercial and noncommercial aviation) that travels through airspace for which the United States provides air traffic control services, but that neither lands in nor takes off from a point in the United States. These fees are imposed and collected by the FAA with respect to mileage actually flown, and apply both to travel within U.S. territorial airspace and to travel within international oceanic airspace for which the United States is responsible for providing air traffic control services.

Reasons for Change

The Committee determined that provisions to ensure a long-term, stable funding source for the Airport and Airway Trust Fund should be enacted at this time. As illustrated by the recent events when a shortfall in fiscal year 1997 FAA funding was narrowly averted by an emergency extension of the present-law excise taxes through September 30, 1997, longer-term assurance of these funding needs is imperative. Therefore, the bill extends (with certain modifications) the current Airport and Airway Trust Fund excise taxes for a 10-year period, a move that it is believed will resolve, for this 10-year period, concerns about the availability of adequate user tax revenues to fund the portion of FAA programs to be appropriated from the Airport and Airway Trust Fund.

The Committee determined that limited modifications to the current passenger excise tax structure are warranted to improve the perceived fairness of these taxes. First, the Committee was very concerned that, under present law, passengers traveling in international transportation pay significantly less tax for transportation involving comparable FAA services than do entirely domestic passengers. The Committee believes it unfair for American families traveling domestically on, e.g., family vacations, to be required to subsidize persons engaged in this international travel. In particular, the Committee is extremely concerned that domestic passengers flying on entirely domestic flights currently are exempt from tax if they connect to or from another, international flight while passengers on the same flight who do not go on to or arrive from an international destination are fully taxed. Similarly, the Committee believes it is inappropriate that passengers arriving in the United States should not pay any tax for the FAA services they receive. To achieve greater equity in the air transportation user taxes, the bill extends the tax to internationally arriving passengers, reclassifies domestic segments of international travel as domestic transportation, and clarifies that the tax applies to payments to airlines (and related parties) from credit card and other companies in exchange for the right to award frequent flyer miles or other reduced air travel rights.

The Committee further believes that continued availability of air transportation services to rural areas is an important national objective. Accordingly, the bill provides a special, reduced tax rate for flight segments to and from smaller rural airports.

Explanation of Provisions

Extension of Airport and Airway Trust Fund taxes

The Airport and Airway Trust Fund excise taxes, as modified below, are extended for 10 years, for the period October 1, 1997, through September 30, 2007. The taxes that are extended include the domestic and international air passenger excise taxes, the air cargo excise tax, and the noncommercial aviation fuels taxes. Gross receipts from these taxes will continue to be deposited in the Airport and Airway Trust Fund.

Modification of commercial air passenger transportation taxes

Tax on international arrivals and departures; treatment of domestic flight segments associated with international travel.—The current $6 international departure tax is increased to $8 per departure, and an identical $8 per passenger tax is imposed on arrivals in the United States from international locations. The definition of international transportation is modified to eliminate domestic flight segments associated with that travel (which are taxed the same as other domestic transportation under the bill). Thus, the $8 per passenger tax applies to all uninterrupted flight segments between a point in the United States and a point in a foreign country.

Under the bill, domestic flight segments associated with international transportation are taxed the same as other domestic flights. Domestic flight segments are flight segments between two U.S. points (or between a U.S. point and a point within the 225-mile zone) from which the passenger continues to or from an international flight. The 10-percent domestic tax rate applies to all such flight segments. The portion of a passenger's fare that is subject to this tax is equal to the percentage of total travel miles covered by the fare (determined based on the aggregate number of miles in all of the flight segments) that the domestic flight segment miles comprise. For this purpose, flight miles are "Great Circle" miles unless the Treasury Department develops another measure (such as predominate routed mileage). Great Circle miles are based on the shortest distance (i.e., "as the crow flies") between two points. In general, this mileage calculation is identical to that which is used by frequent flyer programs offered by all major U.S. airlines today. Computer programs are readily available for calculating "Great Circle" miles between origin and destination points for flights.

These provisions are illustrated by the following example. Assume that a passenger travels from Paris to Los Angeles with a intermediate stop and aircraft change in New York. The passenger is subject to an $8 tax on the flight segment from Paris to New York. Assume further that 50 percent of the aggregate miles on the London to Los Angeles trip are attributable to travel between New York and Los Angeles. In this case, 50 percent of the fare is subject to the 10-percent *ad valorem* tax for the flight segment between New York and Los Angeles. The combined tax amount (international and domestic rate portions) are calculated by the airline and stated on the passenger's ticket.

Special rules applicable to certain transportation.—Transportation between the 48 contiguous States and Alaska or Hawaii (or between those States) remains subject to the special rules provided in present law. Thus, this transportation is taxed on apportioned mileage in U.S. territorial airspace plus $6 per passenger per one-way flight.[102] Clarification is provided that only one $6 per passenger tax is imposed on a single flight segment (despite the fact that such a flight segment technically constitutes both an international departure and an international arrival).

Additionally, the current special provisions governing transportation between the United States and points within the 225-mile zone of Canada or Mexico are retained, with that transportation being taxed on the same basis as other domestic transportation in the circumstances provided under present law (as modified by the provisions of the bill recharacterizing certain domestic flight segments associated with international transportation).

A further special rule is provided for certain flight segments to or from qualified rural airports. A qualified rural airport is an airport that (1) in the second preceding calendar year had fewer than 100,000 commercial passenger enplanements (i.e., departures), and (2) either (a) is not located within 75 miles of another airport that had more than 100,000 such passenger enplanements in that year, or (b) is eligible for payments under the Federal "essential air services" program (as in effect on the date of enactment). Flight segments to or from a qualified rural airport are subject to a reduced, 7.5-percent *ad valorem* rate (in lieu of the general 10-percent rate).[103] The term flight segment is defined as transportation involving a single take-off and a single landing. In the case of transportation involving multiple flight segments, the portion of the fare allocable to the rural segment is determined based on the number of Great Circle miles in the rural flight segment as compared to the aggregate number of miles in all of the flight segments. This is the same calculation that is used in apportioning international transportation between taxable international travel and associated domestic flight segments.

[102] This special rule also applies to domestic segments between the contiguous 48 states and Alaska or Hawaii which are associated with international arrivals or departures to or from those States. Thus, the flight segment between the 48 contiguous States and Alaska or Hawaii is subject to a tax of $6 plus 10 percent of the apportioned mileage in U.S. territorial airspace, and the flight segment between Alaska or Hawaii and a foreign country is subject to the new $8 international arrival and departure tax rate.

[103] The Treasury Department is directed to publish an annual list of qualified rural airports, based on passenger enplanements for the requisite calendar year.

Extension of tax to certain currently exempt passengers.—As described above, passengers arriving in the United States from other countries, who currently are the only group of travelers whose transportation is subject neither to an excise tax nor a user fee for U.S.-provided aviation services, are subject to tax on their arriving international flights. Similarly, passengers traveling on domestic flight segments that either connect to or from international flight segments are subject to tax in the same manner as other, entirely domestic passengers.

Clarification further is provided that any amounts paid to air carriers (in cash or in kind) for the right to award or otherwise distribute free or reduced-rate air transportation are treated as amounts paid for taxable air transportation, subject to the 10-percent *ad valorem* tax rate. Examples of such taxable amounts include (1) payments for frequent flyer miles purchased by credit card companies, telephone companies, rental car companies, television networks, restaurants and hotels, and other businesses for distribution to their customers and others (e.g., employees) and (2) amounts received by airlines pursuant to joint venture credit card or other marketing arrangements. The Treasury Department is authorized specifically to disregard accounting allocations or other arrangements which have the effect of reducing artificially the base to which the 10-percent tax is applied. (No inference is intended from this provision as to the proper treatment of these payments under present law.)

Liability for tax.—The present-law provision imposing liability for the tax on passengers (with transportation providers being liable for collecting and remitting revenues to the Federal Government) are modified to impose secondary liability on air carriers. As with the current tax, the aggregate tax will continue to be required to be stated separately on passenger tickets.

Modification of air passenger excise tax deposit rules.—The deposit rules with respect to the commercial air passenger excise taxes are modified to permit payment of these taxes that otherwise would have been required to be deposited during the period August 15, 1997 through September 30, 1997, to be deposited on October 10, 1997. Similarly, tax deposits that would be due during the period July 1, 2001, through September 30, 2001, are required to be made no later than October 10, 2001.

Effective Date

These provisions generally are effective on the date of enactment, for air transportation beginning after September 30, 1997.

Present law requires transportation providers to continue collecting the commercial aviation excise taxes (at the current rates) on transportation to be provided after September 30, 1997, if the transportation is purchased before October 1, 1997. The bill requires transportation providers to collect the taxes at the modified rates for transportation purchased after the date of enactment for travel beginning after September 30, 1997.

The extension of the general aviation fuels excise taxes is effective for fuels removed or sold after September 30, 1997.

The provision clarifying application of the commercial air passenger excise tax to certain amounts paid for the right to award air transportation is effective for amounts paid (or benefits transferred) after September 30, 1997. A special rule provides that payments (or transfers) between related parties occurring after June 16, 1997 and before October 1, 1997, are subject to tax if the payments relate to rights to transportation to be awarded or otherwise distributed after September 30, 1997.

The modifications to the commercial air passenger excise tax deposit rules are effective on the date of enactment.

2. Reinstate Leaking Underground Storage Tank Trust Fund excise tax (sec. 842 of the bill and secs. 4041(d), 4081(a)(2), and 4081(d)(2) of the Code)

Present Law

Before January 1, 1996, an excise tax of 0.1 cent per gallon was imposed on gasoline, diesel fuel (including train diesel fuel), special motor fuels (other than liquefied petroleum gas), aviation fuels, and inland waterways fuels. Revenues from the tax were dedicated to the Leaking Underground Storage Tank Trust Fund to finance cleanups of leaking underground storage tanks.

Reasons for Change

The Committee determined that the Leaking Underground Storage Tank Trust Fund excise tax should be reinstated to ensure the availability of funds to pay cleanup costs of leaking underground storage tanks.

Explanation of Provision

The bill reinstates the prior-law Leaking Underground Storage Tank Trust Fund excise tax through September 30, 2007.

Effective Date

The provision is effective on October 1, 1997.

3. Application of communications tax to long-distance prepaid telephone cards (sec. 843 of the bill and sec. 4251 of the Code)

Present Law

A 3-percent excise tax is imposed on amounts paid for local and toll (long-distance) telephone service and teletypewriter exchange service. The tax is collected by the provider of the service from the consumer (business and residential custormers).

Reasons for Change

The Committee understands that communication service providers sometimes sell units of long-distance service to third parties who, in turn, resell or distribute these units of long-distance telephone service to the ultimate customer in the form of prepaid telephone cards or similar arrangements. The Committee believes that such payments clearly represent payments for long-distance telephone service and clarifies that such payments are subject to the communications excise tax.

Explanation of Provision

The bill provides that any amounts paid to telephone carriers (in cash or in kind) for the right to award or otherwise distribute long-distance telephone service, including free or reduced-rate service, are treated as amounts paid for taxable communication services, subject to the 3-percent *ad valorem* tax rate. Examples of such taxable amounts include (1) prepaid telephone cards offered through service stations, convenience stores and other businesses to their customers and others (e.g., employees) and (2) amounts received by telephone carriers pursuant to joint venture credit card or other marketing arrangements.

For example, company A, which is a telephone carrier that owns telephone transmission and switching equipment and generally offers telephone service to the public, may sell a block of long-distance message units to company B for X dollars. Company B owns no transmission or switching equipment, but rather acts as a reseller of long distance telephone services and also is a telephone carrier. Company B, in turn, resells all or part of the long-distance message units purchased from Company A to Company C for Y dollars. Company C operates a chain of convenience stores. Company C resells some of the long-distance message units in the form of prepaid telephone cards to its convenience store customers and also makes some of the message units available to its employees as a benefit by the free distribution of such prepaid telephone cards to the employees. The amount Y will be considered an amount paid for telecommunications services subject to the 3-percent telephone excise tax. Alternatively, if company C had purchased the block of message units directly from company A for X dollars, the amount X will be considered an amount paid for telecommunications services subject to the 3-percent telephone excise tax.

In the case of amounts received by telecommunications carriers pursuant to joint venture credit card or other marketing arrangements, the Treasury Department is authorized specifically to disregard accounting allocations or other arrangements which have the effect of reducing artificially the base to which the 3-percent tax is applied.

No inference is intended from this provision as to the proper treatment of these payments under present law.

Effective Date

The provision is effective for amounts paid on or after the date of enactment.

4. Uniform rate of excise tax on vaccines (sec. 844 of the bill and secs. 4131 and 4132 of the Code)

Present Law

Under section 4131, a manufacturer's excise tax is imposed on the following vaccines routinely recommended for administration to children: DPT (diphtheria, pertussis, tetanus,), $4.56 per dose; DT (diphtheria, tetanus), $0.06 per dose; MMR (measles, mumps, or rubella), $4.44 per dose; and polio, $0.29 per dose. In general, if any vaccine is administered by combining more than one of the listed taxable vaccines, the amount of tax imposed is the sum of the amounts of tax imposed for each taxable vaccine. However, in the case of MMR and its components, any component vaccine of MMR is taxed at the same rate as the MMR-combined vaccine.

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund to finance compensation awards under the Federal Vaccine Injury Compensation Program for individuals who suffer certain injuries following administration of the taxable vaccines. This program provides a substitute Federal, "no fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers. All persons immunized after September 30, 1998, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

Reasons for Change

The Committee understands that the present-law tax rates applicable to taxable vaccines were chosen to reflect estimated probabilities of adverse reactions and the severity of the injury that might result from such reactions. The Committee understands that medical researchers believe that there is insufficient data to support fine gradations of estimates of potential harm from the various different childhood vaccines. In the light of this scientific assessment, the Committee believes some simplicity can be achieved by taxing such vaccines at the same rate per dose.

The Committee further believes it is appropriate to review the list of taxable vaccines from time to time as medical science advances. The Center for Disease Control has recommended that the vaccines for HIB (haemophilus influenza type B), Hepatitis B, and varicella (chicken pox) be widely administered among the nation's children. In light of the growing number of immunizations using these vaccines, the Committee adds these vaccines to the list of taxable vaccines.

Explanation of Provision

The bill replaces the present-law excise tax rates, that differ by vaccine, with a single rate tax of $0.84 per dose on any listed vaccine component. Thus, the bill provides that the tax applied to any vaccine that is a combination of vaccine components is 84 cents times the number of components in the combined vaccine. For example, the MMR vaccine is to be taxed at a rate of $2.52 per dose and the DT vaccine is to be taxed at rate of $1.68 per dose.

In addition, the provision adds three new taxable vaccines to the present-law taxable vaccines: (1) HIB (haemophilus influenza type B); (2) Hepatitis B; and (3) varicella (chicken pox). The three newly listed vaccines also are subject to the 84-cents per dose excise tax.

Lastly, the Committee directs the Secretary of the Treasury to undertake a study of the efficacy of the new flat-rate vaccine tax system as a means to finance the Vaccine Injury Compensation Trust Fund. Among other issues that the Secretary might find pertinent, the Committee directs the Secretary to explore the following questions. For each taxable vaccine, how does the magnitude of the tax compare to the total price of the vaccine that is charged to the patient (or the patient's insurance company)? Have any changes in the prices of taxable vaccines that might have resulted from the changes in tax enacted by this bill altered the use of taxable vaccines (i.e., what is the price elasticity of demand for the various taxable vaccines)? Does scientific evidence exist to permit a vaccine tax structure that reflects possibly different medical risks from the different vaccines? Does the flat-rate structure generate savings in compliance costs for taxpayers and administrative cost savings for the Internal Revenue Service? The Committee welcomes recommendations regarding possible changes in this tax structure. However, the Committee reminds the Secretary that determination of the tax base and the tax rate are the constitutional prerogative of the Congress and that recommendations for delegation of such authority to the executive branch are inappropriate. The results of the study are to be reported to the Senate Committee on Finance and the House Committee on Ways and Means by September 30, 1999.

Effective Date

The provision is effective for vaccine purchases after September 30, 1997. No floor stocks tax is to be collected or refunds permitted for amounts held for sale on October 1, 1997. Returns to the manufacturer occurring on or after October 1, 1997, are assumed to be returns of vaccines to which the new rates of tax apply.

5. Modify treatment of tires under the heavy highway vehicle retail excise tax (sec. 845 of the bill and sec. 4071 of the Code)

Present Law

A 12-percent retail excise tax is imposed on certain heavy highway trucks and trailers, and on highway tractors. A separate manufacturers' excise tax is imposed on tires weighing more than 40 pounds. This tire tax is imposed as a fixed dollar amount which varies based on the weight of the tire. Because tires are taxed separately, the value of tires installed on a highway vehicle is excluded from the 12-percent excise tax on heavy highway vehicles. The determination of value is factual and has given rise to numerous tax audit challenges.

Reasons for Change

Allowing a credit for the tire tax actually paid on truck tires will simplify the application of the retail truck tax.

Explanation of Provision

The current exclusion of the value of tires installed on a taxable highway vehicle is repealed. Instead, a credit for the amount of manufacturers' excise tax actually paid on the tires is allowed.

Effective Date

The provision is effective after December 31, 1997.

6. Increase tobacco excise taxes (sec. 846 of the bill and sec. 5701 of the Code)

Present Law

The following is a listing of the Federal excise taxes imposed on tobacco products under present law:

Article	Tax imposed
Cigars:	
Small cigars	$1.125 per thousand.
Large cigars	12.75% of manufacturer's price, up to $30 per thousand.
Cigarettes:	
Small cigarettes	$12.00 per thousand (24 cents per pack of 20 cigarettes).
Large cigarettes	$25.20 per thousand.
Cigarette papers	$0.0075 per 50 papers.
Cigarette tubes	$0.15 per 50 tubes.
Chewing tobacco	$0.12 per pound.
Snuff	$0.36 per pound.
Pipe tobacco	$0.675 per pound.

Reasons for Change

The Committee believes it is appropriate to increase taxes on tobacco products. Raising such taxes will have the positive effect of discouraging smoking, particularly smoking by children and teenagers, thereby helping millions of Americans avoid the health hazards that accompany long-term tobacco use.

Explanation of Provision

In general

The bill increases the current excise tax rates on all tobacco products, including cigarettes, cigars, chewing tobacco, snuff, and pipe tobacco, effective October 1, 1997. Floor stocks taxes are imposed on tobacco products at the time of the rate increase (including tobacco products in foreign trade zones).

Specific tax rate increases

The following table shows the specific tobacco excise tax rates under the bill as of October 1, 1997:

Article	Tax rate (October 1, 1997)
Cigars:	
Small cigars	$2.063 per thousand.
Large cigars	23.375% of manufacturer's price, up to $55 per thousand.

Article	Tax rate (October 1, 1997)
Cigarettes:	
Small cigarettes	$22.00 per thousand (44 cents per pack of 20 cigarettes).
Large cigarettes	$46.20 per thousand.
Cigarette papers	$0.0138 per 50 papers.
Cigarette tubes	$0.0275 per 50 tubes.
Chewing tobacco	$0.22 per pound.
Snuff	$0.66 per pound.
Pipe tobacco	$1.2375 per pound.
Roll-your-own tobacco	$0.66 per pound.

The bill also includes expanded compliance measures designed to prevent diversion of non-tax-paid tobacco products nominally destined for export for use within the United States.

Effective Date

The provision is effective on October 1, 1997.

F. Provisions Relating to Tax-Exempt Entities

1. Extend UBIT rules to second-tier subsidiaries and amend control test (sec. 851 of the bill and sec. 512(b)(13) of the Code)

Present Law

In general, interest, rents, royalties and annuities received by tax-exempt organizations are not subject to the unrelated business income tax (UBIT). However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as potentially subject to UBIT if such income is received from a taxable or tax-exempt subsidiary that is 80 percent controlled by the parent tax-exempt organization.[104] Rent, royalty, annuity, and interest payments received from a controlled subsidiary are treated as unrelated business income (UBTI) in the hands of the parent organization based on the percentage of the subsidiary's income that is unrelated business taxable income (either in the hands of the subsidiary if the subsidiary is tax-exempt, or in the hands of the parent organization if the subsidiary is taxable).

In the case of a stock subsidiary, the 80 percent control test under section 512(b)(13) is met if the parent organization owns 80 percent or more of the voting stock and all other classes of stock of the subsidiary.[105] In the case of a non-stock subsidiary, the applicable Treasury regulations look to factors such as the representation of the parent corporation on the board of directors of the nonstock subsidiary, or the power of the parent corporation to appoint or remove the board of directors of the subsidiary.[106]

[104] For this purpose, a "controlled organization" is defined under section 368(c).
[105] Treas. reg. sec. 1.512(b)–1(1)(4)(I)(a).
[106] Treas. reg. sec. 1.512(b)–1(1)(4)(I)(b).

The control test under section 512(b)(13) does not, however, incorporate any indirect ownership rules.[107] Consequently, rents, royalties, annuities and interest derived from second-tier subsidiaries generally do not constitute UBTI to the tax-exempt parent organization.[108]

Reasons for Change

Section 512(b)(13) was enacted to prevent subsidiaries of tax-exempt organizations from reducing their otherwise taxable income by borrowing, leasing, or licensing assets from a tax-exempt parent organization at inflated levels. Because section 512(b)(13) was narrowly drafted, organizations were able to circumvent its application through, for example, the issuance of 21 percent of nonvoting stock with nominal value to a separate friendly party or through the use of tiered or brother/sister subsidiaries. The Committee believes that the modifications to the control requirement and inclusion of attribution rules will ensure that section 512(b)(13) operate consistent with its intended purpose.

Explanation of Provision

The bill modifies the test for determining control for purposes of section 512(b)(13). Under the bill, "control" means (in the case of a stock corporation) ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests.

In addition, the bill applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

The bill also makes technical modifications to the method provided in section 512(b)(13) for determining how much of an interest, rent, annuity, or royalty payment made by a controlled entity to a tax-exempt organization is includible in the latter organization's UBTI. Such payments are subject to UBIT to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

Effective Date

The modification of the control test to one based on vote or value, the application of the constructive ownership rules of section 318,

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[107] See PLR 9338003 (June 16, 1993) (holding that because no indirect ownership rules are applicable under section 512(b)(13), rents paid by a second-tier taxable subsidiary are not UBTI to a tax-exempt organization). In contrast, an example of an indirect ownership rule can be found in Code section 318. Section 318(a)(2)(C) provides that if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly by or for such corporation, in the proportion the value of the person's stock ownership bears to the total value of all stock in the corporation.

[108] See PLR 9542045 (July 28, 1995) (holding that first-tier holding company and second-tier operating subsidiary were organized with bona fied business functions and were not agents of the tax-exempt parent organization; therefore, rents, royalties, and interest received by tax-exempt parent organization from second-tier subsidiary were not UBTI).

and the technical modifications to the flow-through method apply to taxable years beginning after the date of enactment. The reduction of the ownership threshold for purposes of the control test from 80 percent to more than 50 percent applies to taxable years beginning after December 31, 1998.

2. Limitation on increase in basis of property resulting from sale by tax-exempt entity to related person (sec. 852 of the bill and sec. 1061 of the Code)

Present law

If a tax-exempt entity transfers assets to a controlled taxable entity in a transaction that is treated as a sale, the transferee taxable entity obtains a fair market value basis in the assets. Because the transferor is tax-exempt, no gain is recognized on the transfer except to the extent of certain unrelated business taxable income, if any.

Other provisions of the Code deny certain tax benefits when a transferor and transferee are related parties. For example, losses on sales between related parties are not recognized (sec. 267). As another example, ordinary income treatment, rather than capital gain treatment, is required on a sale of depreciable property between related parties.(sec.1239).

Reasons for Change

The Committee recognizes that a tax-exempt entity can sell assets to a taxable party without recognition of gain, while that party receives a fair market value basis in the property. However, the Committee is concerned that tax-exempt entities may in effect structure transactions in which assets are transferred to taxable entities controlled by the tax-exempt entity, in a form such that a stepped-up basis and depreciation are available to reduce the amount that would otherwise have been taxable unrelated business income, if the tax-exempt entity had converted the same assets to taxable operation and operated the business itself.

Explanation of Provision

In the case of a sale or exchange of property directly or indirectly between a tax-exempt entity and a related person, the basis of the related person in the property will not exceed the adjusted basis of such property immediately before the sale in the hands of the tax-exempt entity, increased by the amount of any gain recognized to the tax-exempt entity under the unrelated business taxable income rules of section 511.

A tax-exempt entity for this purpose is defined as in section 168(h)(2)(A), without regard to section (iii) of that section.

A related person means any person having a relationship to the tax-exempt entity described in section 267(b) or 707(b)(1) (generally, certain more-than-50-percent relationships, with specified attribution rules). For purposes of applying section 267(b)(2), such an entity is treated as if it were an individual.

Effective Date

The provision applies to sales or exchanges after June 8, 1997; except that it will not apply to a sale or exchange made pursuant to a written agreement which was binding on such date and at all times thereafter.

3. Repeal grandfather rule with respect to pension business of insurer (sec. 853 of the bill and sec. 1012(c) of the Tax Reform Act of 1986)

Present Law

Present law provides that an organization described in sections 501(c)(3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. When this rule was enacted in 1986, certain treatment (described below) applied to Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year.

The treatment applicable to such organizations, which became taxable organizations under the provision, is as follows. A special deduction applies with respect to health business equal to 25 percent of the claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the year. An exception is provided for such organizations from the application of the 20-percent reduction in the deduction for increases in unearned premiums that applies generally to property and casualty insurance companies. A fresh start was provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment was made under section 481 on account of an accounting method change. Such an organization was required to compute its ending 1986 loss reserves without artificial changes that would reduce 1987 income. Thus, any reserve weakening after August 16, 1986 was treated as occurring in the organization's first taxable year beginning after December 31, 1986. The basis of such an organization's assets was deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1986, for purposes of determining gain or loss (but not for determining depreciation or for other purposes).

Grandfather rules were provided in the 1986 Act relating to the provision. It was provided that the provision does not apply with respect to that portion of the business of Mutual of America which is attributable to pension business. Pension business means the administration of any plan described in section 401(a) of the Code which includes a trust exempt from tax under section 501(a), and plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b) of the

Code, any individual retirement plan described in section 408 of the Code, and any eligible deferred compensation plan to which section 457(a) of the Code applies.

Reasons for Change

The Committee is concerned that the continued tax-exempt status of an organization that engages in insurance activities with respect pension business gives such an organization an unfair competitive advantage. Thus, the Committee believes, it is no longer appropriate to continue the grandfather rule.

Explanation of Provision

The provision repeals the grandfather rule applicable to that portion of the business of Mutual of America which is attributable to pension business. Mutual of America is to be treated for Federal tax purposes as a life insurance company.

A fresh start is provided with respect to changes in accounting methods resulting from the change from tax-exempt to taxable status. Thus, no adjustment is made under section 481 on account of an accounting method change. Mutual of America is required to compute ending 1997 loss reserves without artificial changes that would reduce 1998 income. Thus, any reserve weakening after June 8, 1997, is treated as occurring in the organization's first taxable year beginning after December 31, 1997. The basis of assets of Mutual of America is deemed to be equal to the amount of the assets' fair market value on the first day of the organization's taxable year beginning after December 31, 1997, for purposes of determining gain or loss (but not for determining depreciation, amortization or for other purposes).

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

G. Foreign Provisions

1. Inclusion of income from notional principal contracts and stock lending transactions under subpart F (sec. 861 of the bill and sec. 954 of the Code)

Present Law

Under the subpart F rules, the U.S. 10-percent shareholders of a controlled foreign corporation ("CFC") are subject to U.S. tax currently on certain income earned by the CFC, whether or not such income is distributed to the shareholders. The income subject to current inclusion under the subpart F rules includes, among other things, "foreign personal holding company income."

Foreign personal holding company income generally consists of the following: dividends, interest, royalties, rents and annuities; net gains from sales or exchanges of (1) property that gives rise to the foregoing types of income, (2) property that does not give rise to income, and (3) interests in trusts, partnerships, and REMICs; net gains from commodities transactions; net gains from foreign currency transactions; and income that is equivalent to interest. Income from notional principal contracts referenced to commodities, foreign currency, interest rates, or indices thereon is treated as foreign personal holding company income; income from equity swaps or other types of notional principal contracts is not treated as foreign personal holding company income. Income derived from transfers of debt securities (but not equity securities) pursuant to the rules governing securities lending transactions (sec. 1058) is treated as foreign personal holding company income.

Income earned by a CFC that is a regular dealer in the property sold or exchanged generally is excluded from the definition of foreign personal holding company income. However, no exception is available for a CFC that is a regular dealer in financial instruments referenced to commodities.

A U.S. shareholder of a passive foreign investment company ("PFIC") is subject to U.S. tax and an interest charge with respect to certain distributions from the PFIC and gains on dispositions of the stock of the PFIC, unless the shareholder elects to include in income currently for U.S. tax purposes its share of the earnings of the PFIC. A foreign corporation is a PFIC if it satisfies either a passive income test or a passive assets test. For this purpose, passive income is defined by reference to foreign personal holding company income.

Reasons for Change

The Committee understands that income from notional principal contracts and stock-lending transactions is economically equivalent to types of income that are treated as foreign personal holding company income under present law. Accordingly, the Committee believes that the categories of foreign personal holding company income should be expanded to cover such income. In addition, the Committee believes that an exception from the foreign personal holding company income rules should be available for dealers in financial instruments referenced to commodities.

Explanation of Provision

The bill treats net income from all types of notional principal contracts as a new category of foreign personal holding company income. However, income, gain, deduction or loss from a notional principal contract entered into to hedge an item of income in another category of foreign personal holding company income is included in that other category.

The bill treats payments in lieu of dividends derived from equity securities lending transactions pursuant to section 1058 as another new category of foreign personal holding company income.

The bill provides an exception from foreign personal holding company income for certain income, gain, deduction, or loss from transactions (including hedging transactions) entered into in the ordinary course of a CFC's business as a regular dealer in property, forward contracts, options, notional principal contracts, or similar financial instruments (including instruments referenced to commodities).

These modifications to the definition of foreign personal holding company income apply for purposes of determining a foreign corporation's status as a PFIC.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

2. Restrict like-kind exchange rules for certain personal property (sec. 862 of the bill and sec. 1031 of the Code)

Present Law

Like-kind exchanges

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment (sec. 1031). In general, any kind of real estate is treated as of a like-kind with other real property as long as the properties are both located either within or both outside the United States. In addition, certain types of property, such as inventory, stocks and bonds, and partnership interests, are not eligible for nonrecognition treatment under section 1031.

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange.

Application of depreciation rules

Tangible personal property that is used predominantly outside the United States generally is accorded a less favorable depreciation regime than is property that is used predominantly within the United States. Thus, under present law, if a taxpayer exchanges depreciable U.S. property with a low adjusted basis (relative to its fair market value) for similar property situated outside the United States, the adjusted basis of the acquired property will be the same as the adjusted basis of the relinquished property, but the depreciation rules applied to such acquired property generally will be different than the rules that were applied to the relinquished property.

Reasons for Change

The committee believes that the depreciation rules applicable to foreign- and domestic-use are sufficiently dissimilar so as to treat such property as not "like-kind" property for purposes of section 1031.

Explanation of Provision

The bill provides that personal property predominantly used within the United States and personal property predominantly used outside the United States are not "like-kind" properties. For this purpose, the use of the property surrendered in the exchange will be determined based upon the use during the 24 months immediately prior to the exchange. Similarly, for section 1031 to apply, property received in the exchange must continue in the same use (i.e., foreign or domestic) for the 24 months immediately after the exchange.

The 24-month period is reduced to such lesser time as the taxpayer held the property, unless such shorter holding period is a result of a transaction (or series of transactions) structured to avoid the purposes of the provision. Property described in section 168(g)(4) (generally, property used both within and without the United States that is eligible for accelerated depreciation as if used in the United States) will be treated as property predominantly used in the United States.

Effective Date

The provision is effective for exchanges after June 8, 1997, unless the exchange is pursuant to a binding contract in effect on such date and all times thereafter. A contract will not fail to be considered to be binding solely because (1) it provides for a sale in lieu of an exchange or (2) either the property to be disposed of as relinquished property or the property to be acquired as replacement property (whichever is applicable) was not identified under the contract before June 9, 1997.

3. Holding period requirement for certain foreign taxes (sec. 863 of the bill and new sec. 901(k) of the Code)

Present Law

A U.S. person that receives a dividend from a foreign corporation generally is entitled to a credit for income taxes paid to a foreign government on the dividend, regardless of the U.S. person's holding period for the foreign corporation's stock. A U.S. corporation that receives a dividend from a foreign corporation in which it has a 10-percent or greater voting interest may be entitled to a credit for the foreign taxes paid by the foreign corporation, also without regard to the U.S. shareholder's holding period for the corporation's stock (secs. 902 and 960).

As a consequence of the foreign tax credit limitations of the Code, certain taxpayers are unable to utilize their creditable foreign taxes to reduce their U.S. tax liability. U.S. shareholders that are tax-exempt receive no U.S. tax benefit for foreign taxes paid on dividends they receive.

Reasons for Change

Although present law imposes a holding period requirement for the dividends-received deduction for a corporate shareholder (sec. 246), there is no similar holding period requirement for foreign tax credits with respect to dividends. As a result, some U.S. persons have engaged in tax-motivated transactions designed to transfer foreign tax credits from persons that are unable to benefit from such credits (such as a tax-exempt entity or a taxpayer whose use of foreign tax credits is prevented by the limitation) to persons that can use such credits. These transactions sometimes involve a short-term transfer of ownership of dividend-paying shares. Other transactions involve the use of derivatives to allow a person that cannot benefit from the foreign tax credits with respect to a dividend to retain the economic benefit of the dividend while another person receives the foreign tax credit benefits.

Explanation of Provision

The bill denies a shareholder the foreign tax credits normally available with respect to a dividend from a corporation or a regulated investment company ("RIC") if the shareholder has not held the stock for a minimum period during which it is not protected from risk of loss. Under the bill, the minimum holding period for dividends on common stock is 16 days. The minimum holding period for preferred stock is 46 days.

Where the holding period requirement is not met for stock of a foreign corporation, the bill disallows the foreign tax credits for the foreign withholding taxes that are paid with respect to a dividend. Such credits are denied both to the shareholder and any other taxpayer who would otherwise be entitled to claim foreign tax credits for such withholding taxes. In addition, the bill applies to all foreign tax credits otherwise allowable for taxes paid by a lower-tier foreign corporation and for foreign tax credits of a RIC that elects to treat its foreign taxes as paid by the shareholders. The bill denies such credits where any of the stock in the chain of ownership that is a requirement for claiming the credits is held for less than the required holding period.

The bill denies these same foreign tax credit benefits, regardless of the shareholder's holding period for the stock, to the extent that the taxpayer has an obligation to make payments related to the dividend (whether pursuant to a short sale or otherwise) with respect to substantially similar or related property.

The 16- or 46-day holding period under the bill (whichever applies) must be satisfied over a period immediately before or immediately after the shareholder becomes entitled to receive each dividend. For purposes of determining whether the required holding period is met, any period during which the shareholder has protected itself from risk of loss (under the rules of section 246(c)(4)) would not be included. For example, assume a taxpayer buys foreign common stock. Assume also that, the day after the stock is purchased, the taxpayer enters into an equity swap under which the taxpayer is entitled to receive payments equal to the losses on the stock, and the taxpayer retains the swap position for the entire period it holds the stock. Under the bill, the taxpayer would not be able to claim any foreign tax credits with respect to dividends on the stock because the taxpayer's holding period is limited to the single day during which the loss on the stock was not protected. For purposes of entitlement to certain indirect foreign tax credits (secs. 902 and 960), the bill provides an exception from the risk reduction rule for a *bona fide* contract to sell stock.

The bill also provides an exception for foreign tax credits with respect to certain dividends received by active dealers in securities. In order to qualify for the exception, the following requirements must be met: (1) The dividend must be received by the entity on stock which it holds in its capacity as a dealer in securities, (2) the entity must be subject to net income taxation on the dividend (on either a residence or worldwide income basis) in a foreign country, and (3) the foreign taxes to which the exception applies must be taxes that are creditable under the foreign county's tax system. A securities dealer for purposes of the exception must be an entity which (1) is engaged in the active conduct of a securities business in a foreign country and (2) is registered as a securities broker or dealer under the Securities Exchange Act of 1934 or is licensed or authorized to conduct securities activities in such foreign county and subject to *bona fide* regulation by the securities regulatory authority of the foreign country. Under the bill, the Secretary of the Treasury is granted authority to issue regulations appropriate to prevent abuse of this exception.

If a taxpayer is denied foreign tax credits under the bill because the 16- or 46-day holding period requirement is not satisfied, the taxpayer would be entitled to a deduction for the foreign taxes for which the credit is disallowed. This deduction would be available even if the taxpayer claimed the foreign tax credit for other taxes in the same taxable year.

No inference is intended as to the treatment under present law of tax-motivated transactions intended to transfer foreign tax credit benefits.

Effective Date

The provision is effective for dividends paid or accrued more than 30 days after the date of enactment.

4. Treatment of income from certain sales of inventory as U.S. source (sec. 864 of the bill and sec. 865 of the Code)

Present Law

U.S. persons are subject to U.S. tax on their worldwide income. A credit against U.S. tax on foreign source income is allowed for foreign taxes. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Specific rules apply in determining whether income is from U.S. or foreign sources. Income from the sale or exchange of inventory property generally is sourced where the sale occurs. In *Liggett Group, Inc*. v. *Commissioner,* 58 T.C.M. 1167 (1990), the court concluded that a sale of inventory property by a U.S. corporation to U.S. customers gave rise to foreign source income because the sale occurred outside the United States.

Reasons for Change

The Committee believes that when a U.S. person sells inventory to its U.S. customers, the resulting income is inherently domestic, regardless of the site of the particular transaction. The Committee believes that income from sales of inventory property by a U.S. resident to another U.S. resident for use in the United States should be treated as income from U.S. sources, without regard to where the sale occurs.

Explanation of Provision

Under the bill, income from a sale of inventory property by a U.S. resident to another U.S. resident for use, consumption, or disposition in the United States is treated as U.S. source income, if the sale is not attributable to an office or other fixed place of business maintained by the seller outside the United States.

Effective Date

The provision is effective for taxable years beginning after date of enactment.

5. Interest on underpayment reduced by foreign tax credit carryback (sec. 865 of the bill and secs. 6601 and 6611 of the Code)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are applied to specific categories of income. The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years.

For purposes of the computation of interest on overpayments of tax, if an overpayment for a taxable year results from a foreign tax credit carryback from a subsequent taxable year, the overpayment is deemed not to arise prior to the filing date for the subsequent taxable year in which the foreign taxes were paid or accrued (sec. 6611(g)). Accordingly, interest does not accrue on the overpayment prior to the filing date for the year of the carryback that effectively created such overpayment. In *Fluor Corp*. v. *United States,* 35 Fed. Cl. 520 (1996), the court held that in the case of an underpayment of tax (rather than an overpayment) for a taxable year that is eliminated by a foreign tax credit carryback from a subsequent taxable year, interest does not accrue on the underpayment that is eliminated by the foreign tax credit carryback. The Government has filed an appeal in the *Fluor* case.

Reasons for Change

The Committee believes that the application of the interest rules in the case of a deficiency that is reduced or eliminated by a foreign tax credit carryback must be consistent with the application of the interest rules in the case of an overpayment that is created by a foreign tax credit carryback. The Committee believes that in such cases the deficiency cannot be considered to have been eliminated, and the overpayment cannot be considered to have been created, until the filing date for the taxable year in which the foreign tax credit carryback arises. Accordingly, interest should continue to accrue on the deficiency through such date. In addition, the Committee believes that it is appropriate to clarify the interest rules that apply in the case of a foreign tax credit carryback that is itself triggered by another carryback from a subsequent year.

Explanation of Provision

Under the bill, if an underpayment for a taxable year is reduced or eliminated by a foreign tax credit carryback from a subsequent taxable year, such carryback does not affect the computation of interest on the underpayment for the period ending with the filing date for such subsequent taxable year in which the foreign taxes were paid or accrued. The bill also clarifies the application of the interest rules of both section 6601 and section 6611 in the case of a foreign tax credit carryback that is triggered by a net operating loss or net capital loss carryback; in such a case, a deficiency is not considered to have been reduced, and an overpayment is not considered to have been created, until the filing date for the subsequent year in which the loss carryback arose. No inference is intended regarding the computation of interest under present law in the case of a foreign tax credit carryback (including a foreign tax credit carryback that is triggered by a net operating loss or net capital loss carryback).

Effective Date

The provision is effective for foreign taxes actually paid or accrued in taxable years beginning after date of enactment.

6. Determination of period of limitations relating to foreign tax credits (sec. 866 of the bill and sec. 6511(d) of the Code)

Present Law

U.S. persons may credit foreign taxes against U.S. tax on foreign source income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are applied to specific categories of income. The amount of creditable taxes paid or accrued in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and carried forward five years.

For purposes of the period of limitations on filing claims for credit or refund, in the case of a claim relating to an overpayment attributable to foreign tax credits, the limitations period is ten years from the filing date for the taxable year with respect to which the claim is made. The Internal Revenue Service has taken the position that, in the case of a foreign tax credit carryforward, the period of limitations is determined by reference to the year in which the foreign taxes were paid or accrued (and not the year to which the foreign tax credits are carried) (Rev. Rul. 84-125, 1984-2 C.B. 125). However, the court in *Ampex Corp*. v. *United States,* 620 F.2d 853 (1980), held that, in the case of a foreign tax credit carryforward, the period of limitations is determined by reference to the year to which the foreign tax credits are carried (and not the year in which the foreign taxes were paid or accrued).

Reasons for Change

The Committee believes that it is appropriate to identify clearly the date on which the ten-year period of limitations for claims with respect to foreign tax credits begins.

Explanation of Provision

Under the bill, in the case of a claim relating to an overpayment attributable to foreign tax credits, the limitations period is determined by reference to the year in which the foreign taxes were paid or accrued (and not the year to which the foreign tax credits are carried). No inference is intended regarding the determination of such limitations period under present law.

Effective Date

The provision is effective for foreign taxes paid or accrued in taxable years beginning after date of enactment.

7. Modify foreign tax credit carryover rules (sec. 867 of the bill and sec. 904 of the Code)

Present Law

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

The amount of creditable taxes paid or accrued (or deemed paid) in any taxable year which exceeds the foreign tax credit limitation is permitted to be carried back two years and forward five years. The amount carried over may be used as a credit in a carryover year to the extent the taxpayer otherwise has excess foreign tax credit limitation for such year. The separate foreign tax credit limitations apply for purposes of the carryover rules.

Reasons for Change

The Committee believes that reducing the carryback period for foreign tax credits to one year and increasing the carryforward period to seven years will reduce some of the complexity associated with carrybacks while continuing to address the timing differences between U.S. and foreign tax rules.

Explanation of Provision

The bill reduces the carryback period for excess foreign tax credits from two years to one year. The bill also extends the excess foreign tax credit carryforward period from five years to seven years.

Effective Date

The provision applies to foreign tax credits arising in taxable years beginning after December 31, 1997.

8. Repeal special exception to foreign tax credit limitation for alternative minimum tax purposes (sec. 864 of the bill and sec. 59 of the Code)

Present Law

Present law imposes a minimum tax on a corporation to the extent the taxpayer's minimum tax liability exceeds its regular tax liability. The corporate minimum tax is imposed at a rate of 20 percent on alternative minimum taxable income in excess of a phased-out $40,000 exemption amount.

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

The Omnibus Budget Reconciliation Act of 1989 ("1989 Act") provided a special exception to the limitation on the use of the foreign tax credit against the tentative minimum tax. In order to qualify for this exception, a corporation must meet four requirements. First, more than 50 percent of both the voting power and value of the stock of the corporation must be owned by U.S. persons who are not members of an affiliated group which includes such corporation. Second, all of the activities of the corporation must be conducted in one foreign country with which the United States has an income tax treaty in effect and such treaty must provide for the exchange of information between such country and the United States. Third, the corporation generally must distribute to its shareholders all current earnings and profits (except for certain amounts utilized for normal maintenance or capital expenditures related to its existing business). Fourth, all of such distributions which are received by U.S. persons must be utilized by such persons in a U.S. trade or business. This exception applies to taxable years beginning after March 31, 1990 (with a proration rule effective for certain taxable years which include March 31, 1990).

Reasons for Change

The committee believes that taxpayers should be treated the same with respect to the foreign tax credit limitation of the alternative minimum tax.

Explanation of Provision

The special exception regarding the use of foreign tax credits for purposes of the alternative minimum tax, as provided by the 1989 Act, is repealed.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

H. Other Revenue-Increase Provisions

1. Phase out suspense accounts for certain large farm corporations (sec. 871 of the bill and sec. 477 of the Code)

Present Law

A corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million. If a farm corporation is required to change its method of accounting, the section 481 adjustment resulting from such change is included in gross income ratably over a 10-year period, beginning with the year of change. This rule does not apply to a family farm corporation.

A provision of the Revenue Act of 1987 ("1987 Act") requires a family corporation (or a partnership with a family corporation as a partner) to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one where at 50 percent or more of the stock of the corporation is held by one (or in some limited cases, two or three) families.

A family farm corporation that must change to an accrual method of accounting as a result of the 1987 Act provision is to establish a suspense account in lieu of including the entire amount of the section 481 adjustment in gross income. The initial balance of the suspense account equals the lesser of (1) the section 481 adjustment otherwise required for the year of change, or (2) the section 481 adjustment computed as if the change in method of accounting had occurred as of the beginning of the taxable year preceding the year of change.

The amount of the suspense account is required to be included in gross income if the corporation ceases to be a family corporation. In addition, if the gross receipts of the corporation attributable to farming for any taxable year decline to an amount below the lesser of (1) the gross receipts attributable to farming for the last taxable year for which an accrual method of accounting was not required, or (2) the gross receipts attributable to farming for the most recent taxable year for which a portion of the suspense account was required to be included in income, a portion of the suspense account is required to be included in gross income.

Reasons for Change

The committee believes that an accrual method of accounting more accurately measures the economic income of a corporation than does the cash receipts and disbursements method and that changes from one method of accounting to another should be taken into account under section 481. However, the committee believes that it may be appropriate for a family farm corporation to retain the use of the cash method of accounting until such corporation reaches a certain size. At that time, the corporation should be subject to tax accounting rules to which other corporations are so subject. In addition, the committee believes that the present-law suspense account provision applicable to large family farm corporations may effectively provide an exclusion for, rather than a deferral of, amounts otherwise properly taken into account under section 481 upon the required change in the method of accounting for such corporations. However, the committee recognizes that requiring the recognition of previously established suspense accounts may impose liquidity concerns upon some farm corporations. Thus, the committee provides an extended period over which existing suspense accounts must be restored to income and provides further deferral where the corporation has insufficient income for the year.

Explanation of Provision

The bill repeals the ability of a family farm corporation to establish a suspense account when it is required to change to an accrual method of accounting. Thus, under the bill, any family farm corporation required to change to an accrual method of accounting would restore the section 481 adjustment applicable to the change in gross income ratably over a 10-year period beginning with the year of change.

In addition, any taxpayer with an existing suspense account is required to restore the account into income ratably over a 20-year period beginning in the first taxable year beginning after June 8, 1997, subject to the present-law requirements to restore such accounts more rapidly. The amount required to be restored to income for a taxable year pursuant to the 20-year spread period shall not exceed the net operating loss of the corporation for the year (in the case of a corporation with a net operating loss) or 50 percent of the net income of the taxpayer for the year (for corporations with taxable income). For this purpose, a net operating loss or taxable income is determined without regard to the amount restored to income under the bill. Any reduction in the amount required to be restored to income is taken into account ratably over the remaining years in the 20-year period or, if applicable, after the end of the 20-year period. Amounts that extend beyond the 20-year period remain subject to the net operating loss and 50-percent-of- taxable income rules.

Finally, the present-law requirement that a portion of a suspense account be restored to income if the gross receipts of the corporation diminishes is repealed.

Effective Date

The provision is effective for taxable years ending after June 8, 1997.

2. Modify net operating loss carryback and carryforward rules (sec. 872 of the bill and sec. 172 of the Code)

Present Law

The net operating loss ("NOL") of a taxpayer (generally, the amount by which the business deductions of a taxpayer exceeds its gross income) may be carried back three years and carried forward 15 years to offset taxable income in such years. A taxpayer may elect to forgo the carryback of an NOL. Special rules apply to real estate investment trusts ("REITs") (no carrybacks), specified liability losses (10-year carryback), and excess interest losses (no carrybacks).

Reason for Change

The committee recognizes that while Federal income tax reporting requires a taxpayer to report income and file returns based on a 12-month period, the natural business cycle of a taxpayer may exceed 12 months. However, the committee believes that allowing a two-year carryback of NOLs is sufficient to account for these business cycles, particularly since (1) many deductions allowed for tax purposes relate to future, rather than past, income streams and (2) certain deductions that do relate to past income streams are granted special, longer carryback periods under present law (which are retained by the bill).

Explanation of Provision

The bill limits the NOL carryback period to two years and extends the NOL carryforward period to 20 years. The bill does not apply to the carryback rules relating to REITs, specified liability losses, excess interest losses, and corporate capital losses.

The bill does not apply to NOLs arising from casualty losses of individual taxpayers. In addition, the bill does not apply to NOLs attributable to losses incurred in Presidentially declared disaster areas by taxpayers engaged in a farming business or a small business. For this purpose, a "small business" means any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) the average annual gross receipts (as determined under sec. 448(c)) of which are $5 million or less, and a "farming business" is defined as in section 263A(e)(4).

Effective Date

The provision is effective for NOLs for taxable years beginning after the date of enactment. The provision does not apply to NOLs carried forward from prior taxable years.

3. Expand the limitations on deductibility of premiums and interest with respect to life insurance, endowment and annuity contracts (sec. 873 of the bill and sec. 264 of the Code)

Present Law

Exclusion of inside buildup and amounts received by reason of death

No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract ("inside buildup").[109] Further, an exclusion from Federal income tax is pro-

[109] This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702). Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated

vided for amounts received under a life insurance contract paid by reason of the death of the insured (sec. 101(a)).

Premium deduction limitation

No deduction is permitted for premiums paid on any 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 taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy (sec. 264(a)(1)).

Interest deduction disallowance with respect to life insurance

Present law provides generally that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance contracts or annuity or endowment contracts owned by the taxpayer covering any individual who is or was (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer (the "COLI" rules).

This interest deduction disallowance rule generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986; rather, an interest deduction limit based on Moody's Corporate Bond Yield Average—Monthly Average Corporates applies in the case of such contracts.[110]

An exception to this interest disallowance rule is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) 5 individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 20 individuals. For determining who is a 20-percent owner, all members of a controlled group are treated as one taxpayer. Interest paid or accrued on debt with respect to a contract covering a key person is deductible only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average—Monthly Average Corporates for each month beginning after December 31, 1995, that interest is paid or accrued.

The foregoing interest deduction limitation was added in 1996 to existing interest deduction limitations with respect to life insurance and similar contracts.[111]

first as a tax-free recovery of basis, and then as income (sec. 72(e)). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10 percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances (secs. 72 (e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than 7 annual level premiums (sec. 7702A). Certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid on the death of the insured (sec. 101(g)).

[110] Phase-in rules apply generally with respect to otherwise deductible interest paid or accrued after December 31, 1995, and before January 1, 1999, in the case of debt incurred before January 1, 1996. In addition, transition rules apply.

[111] Since 1942, a limitation has applied to the deductibility of interest with respect to single premium contracts (sec. 264(a)(2)). For this purpose, a contract is treated as a single premium

Continued

Interest deduction limitation with respect to tax-exempt interest income

Present law provides that no deduction is allowed for interest on debt incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax (sec. 265(a)(2)). In addition, in the case a financial institution, a proration rule provides that no deduction is allowed for that portion of the taxpayer's interest that is allocable to tax-exempt interest (sec. 265(b)). The portion of the interest deduction that is disallowed under this rule generally is the portion determined by the ratio of the taxpayer's (1) average adjusted bases of tax- exempt obligations acquired after August 7, 1986, to (2) the average adjusted bases for all of the taxpayer's assets (sec. 265(b)(2)).[112]

Reasons for Change

The Committee understands that, under applicable State laws, the holder of a life insurance policy generally is required to have an insurable interest in the life of the insured individual only when the policyholder purchases the life insurance policy. The Committee understands that under State laws relating to insurable interests, a taxpayer generally has an insurable interest in the lives of its debtors. Further, rules governing permitted investments of financial institutions may allow the institutions to acquire cash value life insurance covering the lives of debtors, as well as the lives of individuals with other relationships to the taxpayer such as shareholders, employees or officers. In addition, insurable interest laws in many States have been expanded in recent years, and States could decide in the future to expand further the range of persons in whom a taxpayer has an insurable interest.

For example, a business could purchase cash value life insurance on the lives of its debtors, and increase the investment in these contracts as the debt diminishes and even after the debt is repaid. If a mortgage lender can (under applicable State law and banking regulations) buy a cash value life insurance policy on the lives of mortgage borrowers, the lender may be able to deduct premiums or interest on debt with respect to such a contract, if no other deduction disallowance rule or principle of tax law applies to limit the deductions. The premiums or interest could be deductible even after the individual's mortgage loan is sold to another lender or to a mortgage pool. If the loan were sold to a second lender, the second lender might also be able to buy a cash value life insurance contract on the life of the same borrower, and to deduct premiums or interest with respect to that contract. The Committee bill addresses this issue by providing that no deduction is allowed for pre-

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contract if (1) substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or (2) an amount is deposited with the insurer for payment of a substantial number of future premiums on the contract. Further, under a limitation added in 1964, no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, endowment, or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (sec. 264(a)(3)). An exception to the latter rule is provided, permitting deductibility of interest on bona fide debt that is part of such a plan, if no part of the annual premiums due during the first 7 years is paid by means of debt (the "4-out-of-7 rule") (sec. 264(c)(1)). In addition to the specific disallowance rules of section 264, generally applicable principles of tax law apply.

[112] Special rules apply for certain tax-exempt obligations of small issuers (sec. 165(b)(3)).

miums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract, and by providing that no deduction is allowed for interest paid or accrued on any indebtedness with respect to life insurance policy, or endowment or annuity contract, covering the life of any individual.

In addition, the Committee understands that taxpayers may be seeking new means of deducting interest on debt that in substance funds the tax-free inside build-up of life insurance or the tax-deferred inside buildup of annuity and endowment contracts.[113] The Committee believes that present law was not intended to promote tax arbitrage by allowing financial or other businesses that have the ongoing ability to borrow funds from depositors, bondholders, investors or other lenders to concurrently invest a portion of their assets in cash value life insurance contracts, or endowment or annuity contracts. Therefore, the bill provides that, for taxpayers other than natural persons, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values of any life insurance policy or annuity or endowment contract issued after June 8, 1997.

Explanation of Provision

Expansion of premium deduction limitation to individuals in whom taxpayer has an insurable interest

Under the provision, the present-law premium deduction limitation is modified to provide that no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.

Expansion of interest disallowance to individuals in whom taxpayer has insurable interest

Under the provision, no deduction is allowed for interest paid or accrued on any indebtedness with respect to life insurance policy, or endowment or annuity contract, covering the life of any individual. Thus, the provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest when the contract is first issued under applicable State law, except as otherwise provided under present law with respect to key persons and pre-1986 contracts.

Pro rata disallowance of interest on debt to fund life insurance

In the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997. Interest expense is so allocable based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment

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[113] See "Fannie Mae Designing a Program to Link Life Insurance, Loans, "Washington Post, p. E3, February 8, 1997; "Fannie Mae Considers Whether to Bestow Mortgage Insurance," *Wall St. Journal*, p. C1, April 22, 1997.

contracts, issued after June 8, 1997, to (2) the average adjusted bases for all assets of the taxpayer. This rule does not apply to any policy or contract owned by an entity engaged in a trade or business, covering any individual who is an employee, officer or director of the trade or business at the time first covered by the policy or contract. Such a policy or contract is not taken into account in determining unborrowed policy cash values.

The unborrowed policy cash values means the cash surrender value of the policy or contract determined without regard to any surrender charge, reduced by the amount of any loan with respect to the policy or contract. The cash surrender value is to be determined without regard to any other contractual or noncontractual arrangement that artificially depresses the cash value of a contract.

If a trade or business (other than a sole proprietorship or a trade or business of performing services as an employee) is directly or indirectly the beneficiary under any policy or contract, then the policy or contract is treated as held by the trade or business. For this purpose, the amount of the unborrowed cash value is treated as not exceeding the amount of the benefit payable to the trade or business. In the case of a partnership or S corporation, the provision applies at the partnership or corporate level. The amount of the benefit is intended to take into account the amount payable to the business under the contract (e.g., as a death benefit) or pursuant to another agreement (e.g., under a split dollar agreement). The amount of the benefit is intended also to include any amount by which liabilities of the business would be reduced by payments under the policy or contract (e.g., when payments under the policy reduce the principal or interest on a liability owed to or by the business).

As provided in regulations, the issuer or policyholder of the life insurance policy or endowment or annuity contract is required to report the amount of the amount of the unborrowed cash value in order to carry out this rule.

If interest expense is disallowed under other provisions of section 264 (limiting interest deductions with respect to life insurance policies or endowment or annuity contracts) or under section 265 (relating to tax-exempt interest), then the disallowed interest expense is not taken into account under this provision, and the average adjusted bases of assets is reduced by the amount of debt, interest on which is so disallowed. The provision is applied before present-law rules relating to capitalization of certain expenses where the taxpayer produces property (sec. 263A).

An aggregation rule is provided, treating related persons as one for purposes of the provision.

The provision does not apply to any insurance company subject to tax under subchapter L of the Code. Rather, the rules reducing certain deductions for losses incurred, in the case of property and casualty companies, and reducing reserve deductions or dividends received deductions of life insurance companies, are modified to take into account the increase in cash values of life insurance policies or annuity or endowment contracts held by insurance companies.

Effective Date

The provisions apply with respect to contracts issued after June 8, 1997. For this purpose, a material increase in the death benefit or other material change in the contract causes the contract to be treated as a new contract. To the extent of additional covered lives under a contract after June 8, 1997, the contract is treated as a new contract. In the case of an increase in the death benefit of a contract that is converted to extended term insurance pursuant to nonforfeiture provisions, in a transaction to which section 501(d)(2) of the Health Insurance Portability and Accountability Act of 1996 applies, the contract is not treated as a new contract.

4. Allocation of basis of properties distributed to a partner by a partnership (sec. 874 of the bill and sec. 732(c) of the Code)

Present Law

In general

The partnership provisions of present law generally permit partners to receive distributions of partnership property without recognition of gain or loss (sec. 731).[114] Rules are provided for determining the basis of the distributed property in the hands of the distributee, and for allocating basis among multiple properties distributed, as well as for determining adjustments to the distributee partner's basis in its partnership interest. Property distributions are tax-free to a partnership. Adjustments to the basis of the partnership's remaining undistributed assets are not required unless the partnership has made an election that requires basis adjustments both upon partnership distributions and upon transfers of partnership interests (sec. 754).

Partner's basis in distributed properties and partnership interest

Present law provides two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (sec. 732(a)). Thus, in a non- liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately be-

[114] Exceptions to this nonrecognition rule apply: (1) when money (and the fair market value of marketable securities) received exceeds a partner's adjusted basis in the partnership (sec. 731(a)(1)); (2) when only money, inventory and unrealized receivables are received in liquidation of a partner's interest and loss is realized (sec. 731(a)(2)); (3) to certain disproportionate distributions involving inventory and unrealized receivables (sec. 751(b)); and (4) to certain distributions relating to contributed property (secs. 704(c) and 737). In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner (sec. 707).

fore the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (sec. 733).

Allocating basis among distributed properties

In the event that multiple properties are distributed by a partnership, present law provides allocation rules for determining their bases in the distributee partner's hands. An allocation rule is needed when the substituted basis rule for liquidating distributions applies, in order to assign a portion of the partner's basis in its partnership interest to each distributed asset. An allocation rule is also needed in a non-liquidating distribution of multiple assets when the total carryover basis would exceed the partner's basis in its partnership interest, so a portion of the partner's basis in its partnership interest is assigned to each distributed asset.

Present law provides for allocation in proportion to the partnership's adjusted basis. The rule allocates basis first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the allocated basis is less than partnership basis, then in proportion to the partnership's basis), and then among other properties in proportion to their adjusted bases to the partnership (sec. 732(c)).[115] Under this allocation rule, in the case of a liquidating distribution, the distributee partner can have a basis in the distributed property that exceeds the partnership's basis in the property.

Reasons for Change

The rule providing that distributee partners allocate basis in proportion to the partnership's adjusted basis in the distributed property gives rise to problems in application.[116] The Committee is concerned that the present-law rule permits basis shifting transactions in which basis is allocated so as to increase basis artificially, giving rise to inflated depreciation deductions or artificially large losses, for example. The Committee believes that these problems would be significantly reduced by taking into account the fair market value of property distributed by a partnership for purposes of allocating basis in the hands of the distributee partner.

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[115] A special rule allows a partner that acquired a partnership interest by transfer within two years of a distribution to elect to allocate the basis of property received in the distribution as if the partnership had a section 754 election in effect (sec. 732(d)). The special rule also allows the Service to require such an allocation where the value at the time of transfer of the property received exceeds 110 percent of its adjusted basis to the partnership (sec. 732(d)). Treas. Reg. sec. 1.732–1(d)(4) generally requires the application of section 732(d) where the allocation of basis under section 732(c) upon a liquidation of the partner's interest would have resulted in a shift of basis from non-depreciable property to depreciable property.

[116] "The failure of these rules to take fair market value into account puts a high premium on tax planning in connection with in-kind liquidating distributions. Allocation of the portion of the basis in excess of the partnership's basis in the distributed assets according to their relative market values would be a conceptually sound approach, and would eliminate the strange results and manipulation possibilities . . ." W. McKee, W. Nelson and R. Whitmire, *Federal Taxation of Partnerships and Partners* (3rd ed. 1997), para. 19.06.

Explanation of Provision

The provision modifies the basis allocation rules for distributee partners. It allocates a distributee partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property (as under present law). If the basis to be allocated is less than the sum of the adjusted bases of the properties in the hands of the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal the basis to be allocated, the decrease is allocated as described below for adjustments that are decreases.

Under the provision, to the extent of any basis not allocated under the above rules, basis is allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. For example, assume that a partnership with two assets, A and B, distributes them both in liquidation to a partner whose basis in its interest is 55. Neither asset consists of inventory or unrealized receivables. Asset A has a basis to the partnership of 5 and a fair market value of 40, and asset B has a basis to the partnership of 10 and a fair market value of 10. Under the provision, basis is first allocated to asset A in the amount of 5 and to asset B in the amount of 10 (their adjusted bases to the partnership). The remaining basis adjustment is an increase totaling 40 (the partner's 55 basis minus the partnership's total basis in distributed assets of 15). Basis is then allocated to asset A in the amount of 35, its unrealized appreciation, with no allocation to asset B attributable to unrealized appreciation because its fair market value equals the partnership's adjusted basis. The remaining basis adjustment of 5 is allocated in the ratio of the assets' fair market values, i.e., 4 to asset A (for a total basis of 44) and 1 to asset B (for a total basis of 11).

If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made). A remaining basis adjustment that is a decrease arises under the provision when the partnership's total adjusted basis in the distributed properties exceeds the amount of the partner's basis in its partnership interest, and the latter amount is the basis to be allocated among the distributed properties. For example, assume that a partnership with two assets, C and D, distributes them both in liquidation to a partner whose basis in its partnership interest is 20. Neither asset consists of inventory or unrealized receivables. Asset C has a basis to the partnership of 15 and a fair market value of 15, and asset D has a basis to the partnership of 15 and a fair market value of 5. Under the provision, basis is first allocated to the extent of the partnership's basis in each distributed property, or 15 to each distributed property, for a total of

30. Because the partner's basis in its interest is only 20, a downward adjustment of 10 (30 minus 20) is required. The entire amount of the 10 downward adjustment is allocated to the property D, reducing its basis to 5. Thus, the basis of property C is 15 in the hands of the distributee partner, and the basis of property D is 5 in the hands of the distributee partner.

Effective Date

The provision applies to partnership distributions after the date of enactment.

5. Treatment of inventory items of a partnership (sec. 875 of the bill and sec. 751 of the Code)

Present Law

Under present law, upon the sale or exchange of a partnership interest, any amount received that is attributable to unrealized receivables, or to inventory that has substantially appreciated, is treated as an amount realized from the sale or exchange of property that is not a capital asset (sec. 751(a)).

Present law provides a similar rule to the extent that a distribution is treated as a sale or exchange of a partnership interest. A distribution by a partnership in which a partner receives substantially appreciated inventory or unrealized receivables in exchange for its interest in certain other partnership property (or receives certain other property in exchange for its interest in substantially appreciated inventory or unrealized receivables) is treated as a taxable sale or exchange of property, rather than as a nontaxable distribution (sec. 751(b)).

For purposes of these rules, inventory of a partnership generally is treated as substantially appreciated if the fair market value of the inventory exceeds 120 percent of adjusted basis of the inventory to the partnership (sec. 751(d)(1)(A)). In applying this rule, inventory property is excluded from the calculation if a principal purpose for acquiring the inventory property was to avoid the rules relating to inventory (sec. 751(d)(1)(B)).

Reasons for Change

The substantial appreciation requirement with respect to inventory of a partnership has been criticized as both ineffective at insulating partnerships from the potential complexity of the disproportionate distribution rules of section 751(b), and also ineffective at properly treating income attributable to inventory as ordinary income under the section 751 rules for partnerships with profit margins below 20 percent.[117] Because the Committee believes that income attributable to inventory should be treated as ordinary in-

[117] The 1984 ALI study on partnership rules referred to the substantial appreciation requirement as subject to manipulation and tax planning (American Law Institute, *Federal Income Tax Project: Subchapter K: Proposals on the Taxation of Partners* (R. Cohen, reporter 1984), 26. In 1993, the definition of substantially appreciated inventory was modified, and the present-law test relating to a principal purpose of avoidance was added (Omnibus Budget Reconciliation Act of 1993, P.L. 103–66, sec. 13206(e)(1)). Nevertheless, the substantial appreciation requirement is still criticized as ineffective (W. McKee, W. Nelson and R. Whitmire, *Federal Taxation of Partners and Partnerships.* (3rd ed. 1997) para. 16.04[2]).

come, the bill repeals the substantial appreciation requirement with respect to inventory, in the case of partnership sales, exchanges and distributions.

Explanation of Provision

The provision eliminates the requirement that inventory be substantially appreciated in order to give rise to ordinary income under the rules relating to sales and exchanges of partnership interests and certain partnership distributions. This conforms the treatment of inventory to the treatment of unrealized receivables under these rules.

Effective Date

The provision is effective for sales, exchanges, and distributions after the date of enactment.

6. Eligibility for income forecast method (sec. 876 of the bill and secs. 167 and 168 of the Code)

Present Law

A taxpayer generally recovers the cost of property used in a trade or business through depreciation or amortization deductions over time. Tangible property generally is depreciated under the modified Accelerated Cost Recovery System ("MACRS") of section 168, which applies specific recovery periods and depreciation methods to the cost of various types of depreciable property. Intangible property generally is amortized under section 197, which applies a 15-year recovery period and the straight-line method to the cost of applicable property.

MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording or to other any property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 does not apply to certain intangible property, including property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be recovered under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost of such property may be depreciated under the "income forecast" method.

The income forecast method is considered to be a method of depreciation not expressed in a term of years. Under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The income forecast method is available to any property if (1) the taxpayer elects to exclude such property from MACRS and (2) for the first taxable year for which depreciation is allowable, the property is properly depreciated under such method. The income forecast method has been held to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings and video games.[118] Most recently, the income forecast method has been held applicable to consumer durable property subject to short-term "rent-to-own" leases.[119]

Reasons for Change

Depreciation allowances attempt to measure the decline in the value of property due to wear, tear, and obsolescence and to match the cost recovery for the property with the income stream produced by the property. The committee believes that the income forecast method of depreciation is, in theory, an appropriate method to match the recovery of cost of property with the income stream produced by the property. However, when compared to MACRS, the income forecast method involves significant complexities, including the determination of the income estimated to be generated by the property, the determination of the residual value of the property, and the application of the look-back method. Thus, the committee believes that the availability of the income forecast method should be limited to instances where the economic depreciation of the property cannot be adequately reflected by the passage of time alone or where the income stream from the property is sufficiently unpredictable or uneven such that the application of another method of depreciation may result in the distortion of income. In addition, because the income forecast method is elective, the committee is concerned about taxpayer selectivity.

Finally, the committee provides a MACRS class life for certain depreciable consumer durables subject to rent-to-own contracts, in order to avoid future controversies with respect to the proper treatment of such property.

Explanation of Provision

The bill clarifies the types of property to which the income forecast method may be applied. Under the bill, the income forecast method is available to motion picture films, television films and taped shows, books, patents, master sound recordings, copyrights, and other such property as designated by the Secretary of the Treasury. It is expected that the Secretary will exercise this authority such that the income forecast method will be available to property the economic depreciation of which cannot be adequately

[118] See, e.g., Rev. Rul. 60–358, 1960–2 C.B. 68; Rev. Rul. 64–273, 1964–2 C.B. 62; Rev. Rul. 79–285, 1979–2 C.B. 91; and Rev. Rul. 89–62, 1989–1 C.B. 78.

[119] See, *ABC Rentals of San Antonio* v. *Comm.,* No. 95–9008 (10th Cir. 9/27/96), where the Tenth Circuit decision reversed the holding of *ABC Rentals of San Antonio* v. *Comm.,* 68 TCM 1362 (1994) and held that consumer durable property subject to short-term, "rent-to-own" leases were eligible for the income forecast method. For decisions supporting the Tax Court memorandum decision denying eligibility for certain tangible personal property, see *El Charro TV Rental* v. *Comm.,* No. 95–60301 (5th Cir., 1995) (rent-to-own property not eligible) and *Carland, Inc.* v. *Comm.,* 90 T.C. 505 (1988), aff'd on this issue, 909 F.2d 1101 (8th Cir., 1990) (railroad rolling stock subject to a lease not eligible))

measured by the passage of time alone or to property the income from which is sufficiently unpredictable or uneven so as to result in the distortion of income. The mere fact that property is subject to a lease should not make the property eligible for the income forecast method. The income forecast method is not applicable to property to which section 197 applies.

In addition, consumer durables subject to rent-to-own contracts are provided a three-year recovery period and a four-year class life for MACRS purposes (and would not be eligible for the income forecast method). Such property generally is described in Rev. Proc. 95–38, 1995–34 I.R.B. 25.

Effective Date

The provision is effective for property placed in service after the date of enactment.

7. Modify the exception to the related party rule of section 1033 for individuals to only provide an exception for de minimis amounts (sec. 877 of the bill and sec. 1033 of the Code)

Present Law

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified replacement period of time. Pursuant to a provision of Public Law 104–7, subchapter C corporations (and certain partnerships with corporate partners) are not entitled to defer gain under section 1033 if the replacement property or stock is purchased from a related person. A person is treated as related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1). An exception to this related party rule provides that a taxpayer could purchase replacement property or stock from a related person and defer gain under section 1033 to the extent the related person acquired the replacement property or stock from an unrelated person within the replacement period.

Reasons for Change

The committee believes that, except for de minimis cases, individuals should be subject to the same rules with respect to the acquisition of replacement property from a related person as are other taxpayers.

Explanation of Provision

The bill expands the present-law denial of the application of section 1033 to any other taxpayer (including an individual) that acquires replacement property from a related party (as defined by secs. 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of $100,000 or less for the taxable year with respect to converted property with aggregate realized gains. In the case of a partnership (or S corporation), the annual $100,000 limitation applies to both the partnership (or S corporation) and each partner (or shareholder).

Effective Date

The provision applies to involuntary conversions occurring after June 8, 1997.

8. Repeal of exception for certain sales by manufacturers to dealer (sec. 878 of the bill and sec. 811(c)(9) of the Tax Reform Act of 1986 (P.L. 99–514))

Present Law

In general, the installment sales method of accounting may not be used by dealers in personal property. Present law provides an exception which permits the use of the installment method for installment obligations arising from the sale of tangible personal property by a manufacturer of the property (or an affiliate of the manufacturer) to a dealer,[120] but only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine month period following the sale to the dealer, and certain other conditions are met. In order to meet the other conditions, the aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50 percent of the total sales to dealers that gave rise to such receivables (the "fifty percent test") in both the taxable year and the preceding taxable year, except that, if the taxpayer met all of the requirements for the exception in the preceding taxable year, the taxpayer would not be treated as failing to meet the fifty percent test before the second consecutive year in which the taxpayer did not actually meet the test. For purposes of applying the fifty percent test, the aggregate face amount of the taxpayer's receivables is computed using the weighted average of the taxpayer's receivables outstanding at the end of each month during the taxpayer's taxable year. In addition, these requirements must be met by the taxpayer in its first taxable year beginning after October 22, 1986, except that obligations issued before that date are treated as meeting the applicable requirements if such obligations were conformed to the requirements of the provision within 60 days of that date.

Reasons for Change

The committee believes that the special exception that permitted certain dealers to use the installment method is no longer necessary or approriate and the installment sale method of accounting should not be available to such dealers. Accordingly, the committee bill repeals that exception.

[120] *I.e.,* the sale of the property must be intended to be for resale or leasing by the dealer.

Explanation of Provision

The bill repeals the exception that permits the use of the installment method of accounting for certain sales by manufacturers to dealers.

Effective Date

The provision is effective for taxable years beginning one year after the date of enactment. Any resulting adjustment from a required change in accounting will be includible ratably over the 4-year taxable years beginning after that date.

9. Cash out of certain accrued benefits (sec. 879 of the bill and secs. 411 and 417 of the Code)

Present Law

Under present law, in the case of an employee whose plan participation terminates, a qualified plan may involuntarily "cash out" the benefit (i.e., pay out the balance to the credit of a plan participant without the participant's consent, and, if applicable, the consent of the participant's spouse) if the present value of the benefit does not exceed $3,500. If a benefit is cashed out under this rule and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which benefits were cashed out unless the employee "buys back" the benefit.

Generally, a cash-out distribution from a qualified plan to a plan participant can be rolled over, tax free, to an IRA or to another qualified plan.

Reasons for Change

The Committee believes that the limit on involuntary cash-outs should be raised to $5,000 in recognition of the effects of inflation and the value of small benefits payable under a qualified pension plan.

Explanation of Provision

The bill increases the limit on involuntary cash-outs to $5,000 from $3,500. The $5,000 amount is adjusted annually for inflation beginning after 1997 in $50 increments. The bill will also make the corresponding changes to the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

Effective Date

The provision is effective for plan years beginning on and after the date of enactment.

10. Election to receive taxable cash compensation in lieu of nontaxable parking benefits (sec. 880 of the bill and sec. 132 of the Code)

Present Law

Under present law, up to $165 per month of employer-provided parking is excludable from gross income. In order for the exclusion to apply, the parking must be provided in addition to and not in lieu of any compensation that is otherwise payable to the employee. Employer-provided parking cannot be provided as part of a cafeteria plan.

Reasons for Change

The Committee believes that the present-law rules relating to employer-provided parking result in an overutilization of parking as a fringe benefit. By permitting employers to offer cash compensation in lieu of parking, the Committee believes that employees will be more likely to elect to receive cash compensation, which will increase the electing employees' taxable income. In addition, the election to take cash may promote sound energy policy by increasing the use of mass transit and reduce the amount of commuting by car.

Explanation of Provision

Under the bill, no amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. The amount of cash offered is includible in income only if the employee chooses the cash instead of parking.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1997.

11. Extension of Federal unemployment surtax (sec. 881 of the bill and sec. 3301 of the Code)

Present Law

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

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8 percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2 percent. The temporary surtax has been subsequently extended through 1998.

Reasons for Change

The Committee believes that the surtax extension will increase the Federal Unemployment Trust Fund to provide a cushion against future expenditures. The monies retained in the Federal Unemployment Account of the Federal Unemployment Trust Fund can then be used to make loans to the 53 State Unemployment Compensation benefit accounts as needed.

Explanation of Provision

The bill extends the temporary surtax rate through December 31, 2007. The bill also increases the limit from 0.25 percent to 0.50 percent of covered wages on the Federal Unemployment Account (FUA) in the Unemployment Trust Fund.

Effective Date

The provision is effective for labor performed on or after January 1, 1999.

12. Repeal of excess distribution and excess retirement accumulation taxes (sec. 882 of the bill and sec. 4980A of the Code)

Present Law

Under present law, a 15-percent excise tax is imposed on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. Excess distributions are generally the aggregate amount of retirement distributions from such plans during any calendar year in excess of $160,000 (for 1997) or 5 times that amount in the case of a lump-sum distribution. The 15-percent excise tax does not apply to distributions received in 1997, 1998, and 1999.

An additional 15-percent estate tax is imposed on an individual's excess retirement accumulations. Excess retirement accumulations are generally the balance in retirement plans in excess of the present value of a benefit that would not be subject to the 15-percent tax in excess distributions.

Reasons for Change

The excess distribution and retirement accumulation taxes are designed to limit the overall tax-deferred savings by individuals, as well as to help ensure that tax-favored retirement vehicles are used primarily for retirement purposes. The Committee believes that the limits on contributions and benefits applicable to each type of vehicle are sufficient limits on tax-deferred savings. Additional penalties are unnecessary, and may also deter individuals from saving.

The excess accumulation and distribution taxes also inappropriately penalize favorable investment returns.

Explanation of Provision

The bill repeals both the 15-percent excise tax on excess distributions and the 15-percent estate tax on excess retirement accumulations.

Effective Date

The provision repealing the excess distribution tax is effective with respect to excess distributions received after December 31, 1996. The repeal of the excess accumulation tax is effective with respect to decedents dying after December 31, 1996.

13. Treatment of charitable remainder trusts with greater than 50 percent annual payout (sec. 883 of the bill and sec. 664 of the Code)

Present Law

In general

Sections 170(f), 2055(e)(2) and 2522(c)(2) disallow a charitable deduction for income, estate or gift tax purposes, respectively, where the donor transfers an interest in property to a charity (*e.g.*, a remainder) while also either retaining an interest in that property (*e.g.*, an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, pooled income funds, farms, and personal residences; (2) present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, (3) an undivided portion of the donor's entire interest in the property, and (4) a qualified conservation easement.

Charitable remainder annuity trusts and charitable remainder unitrusts

A charitable remainder annuity trust is a trust which is required to pay, at least annually, a fixed dollar amount at least 5 percent of the initial value of the trust to a non-charity for the life of an individual or period of less than 20 years, with the remainder passing to charity. A charitable remainder unitrust is a trust which generally is required to pay, at least annually, a fixed percentage of the fair market value of the trust's assets determined at least annually to a non-charity for the life of an individual or period less than 20 years, with the remainder passing to charity. Sec. 664(d).

Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated in the following order as: (1) ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred, (2) capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred; (3) other income (*e.g.*, tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred, and (4) corpus. Sec. 664(b).

Distributions are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year. Treas. Reg. sec. 1.664–1(d)(4).

Reasons for Change

The Committee is concerned that the interplay of the rules governing the timing of income from distributions from charitable remainder trusts (*i.e.*, Treas. Reg. sec. 1.664–1(d)(4)) and the rules governing the character of distributions (*i.e.*, sec. 664(b)) have created opportunities for abuse where the required annual payments are a large portion of the trust and realization of income and gain can be postponed until a year later than the accrual of such large payments. For example, some taxpayers have been creating charitable remainder unitrusts with a required annual payout of 80 percent of the trust's assets and then funding the trust with highly appreciated nondividend paying stock which the trust sells in a year subsequent to when the required distribution is includible in the beneficiary's income, and using proceeds from that sale to pay the required distribution attributable to the prior year. Those taxpayers have treated the distribution of 80 percent of the trust's assets attributable to the trust's first required distribution as nontaxable distributions of corpus because the trust had not realized any income in its first taxable year. The Committee believes that such treatment is abusive and is inconsistent with the purpose of the charitable remainder trust rules. In order to limit this kind of abuse, the Committee bill provides that a trust cannot be a charitable remainder trust if the required payout is greater than 50 percent of the initial fair market value of the trusts assets (in the case of a charitable remainder annuity trust) or 50 percent of the annual value of the trusts assets (in the case of a charitable remainder unitrust).

On April 18, 1997, the Treasury Department proposed regulations providing additional rules under sections 664 and 2702 to address the abuse described above and other perceived abuses involving distributions from charitable remainder trusts. One of those proposed rules would require that payment of any required annuity or unitrust amount by a charitable remainder trust be made by the close of the trust's taxable year in which such payments are due. See Prop. Treas. Reg. secs. 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i). The Committee intends that the provision of the Committee bill does not limit or alter the validity of the regulations proposed by the Treasury Department on April 18, 1997, or the Treasury Department's authority to address this or other abuses of the rules governing the taxation of charitable remainder trusts or their beneficiaries.

Explanation of Provision

Under the provision, a trust would not qualify as charitable remainder annuity trust if the annuity for a year is greater than 50 percent of the initial fair market value of the trust's assets or a trust would not qualify as a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50 percent. Any trust that fails this 50 percent rule will not be a charitable remainder trust whose taxation is governed under section 664, but will be treated as a complex trust and, accordingly, all of its income will be taxed to its beneficiaries or to the trust.

Effective Date

The provision applies to transfers to a trust made after June 18, 1997.

14. Tax on prohibited transactions (sec. 884 of the bill and sec. 4975 of the Code)

Present Law

Present law prohibits certain transactions (prohibited transactions) between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. A two-tier excise tax is imposed on prohibited transactions. The initial level tax was equal to 10-percent of the amount involved with respect to the transaction. If the transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed.

Reasons for Change

The Committee believes it is appropriate to increase the initial level prohibited transaction tax to discourage disqualified persons from engaging in such transactions.

Explanation of Provision

The bill increases the initial-level prohibited transaction tax from 10-percent to 15-percent. No changes were made to the prohibited transaction provisions of title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA').

Effective Date

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

15. Basis recovery rules (sec. 885 of the bill and sec. 72 of the Code)

Present Law

Under present law, amounts received as an annuity under a tax-qualified pension plan generally are includible in income in the year received, except to the extent the amount received represents return of the recipient's investment in the contract (i.e., basis). The portion of each annuity payment that represents a return of basis generally is determined by a simplified method. Under this method, the portion of each annuity payment that is a return to basis is equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under a specified table, shown below. The number of anticipated payments listed in the table is based on the age of the primary annuitant on the annuity starting date.

	Number of Payments
Age of primary annuitant:	
55 or less	360
56–60	310
61–65	260
66–70	210
71 or more	160

If the number of payments is fixed under the terms of the annuity, that number is used instead of the number of anticipated payments listed in the table. The simplified method is not available if the primary annuitant has attained age 75 on the annuity starting date unless there are fewer than 5 years of guaranteed payments under the annuity. If, in connection with commencement of annuity payments, the recipient receives a lump-sum payment that is not part of the annuity stream, such payment is taxable under the rules relating to annuities (sec. 72) as if received before the annuity starting date, and the investment in the contract used to calculate the simplified exclusion ratio for the annuity payments is reduced by the amount of the payment. In no event is the total amount excluded from income as nontaxable return of basis greater than the recipient's total investment in the contract.

Reasons for Change

The table for determining anticipated payments does not differ depending on whether the annuity is payable in the form of a single life annuity or a joint and survivor annuity. Applying the table for single life annuities to joint and survivor annuities understates the expected payments under a joint and survivor annuity.

Explanation of Provision

Under the bill, the present-law table would apply to benefits based on the life of one annuitant. A separate table would apply to benefits based on the life of more than one annuitant, as follows:

	Number of payments
Combined age of annuitants:	
110 or less	410
111–120	360
121–130	310
131–140	260
141 and over	210

Effective Date

The provision is effective with respect to annuity starting dates beginning after December 31, 1997.

TITLE IX. FOREIGN-RELATED SIMPLIFICATION PROVISIONS

1. General provisions affecting treatment of controlled foreign corporations (secs. 911-913 of the bill and secs. 902, 904, 951, 952, 959, 960, 961, 964, and 1248 of the Code)

Present Law

If an upper-tier controlled foreign corporation ("CFC") sells stock of a lower-tier CFC, the gain generally is included in the income of U.S. 10-percent shareholders as subpart F income and such U.S. shareholder's basis in the stock of the first-tier CFC is increased to account for the inclusion. The inclusion is not characterized for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier CFC; instead it generally is characterized as passive income.

For purposes of the foreign tax credit limitations applicable to so-called 10/50 companies, a CFC is not treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC and, except as provided in regulations, the recipient of the distribution was a U.S. 10-percent shareholder in such corporation.

If subpart F income of a lower-tier CFC is included in the gross income of a U.S. 10-percent shareholder, no provision of present law allows adjustment of the basis of the upper-tier CFC's stock in the lower-tier CFC.

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. 10-percent shareholders of the corporation on the last day, in that year, on which the corporation is a CFC. In the case of a U.S. 10-percent shareholder who acquired stock in a CFC during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquiror with respect to that stock.

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the CFC. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

A U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder. A U.S. corporation also may be deemed to have paid taxes paid by a second- or third-tier foreign corporation if certain conditions are satisfied.

Reasons for Change

The Committee believes that complexities are caused by uncertainties and gaps in the present statutory schemes for taxing gains on dispositions of stock in CFCs as dividend income or subpart F income. The Committee believes that it is appropriate to reduce complexities by rationalizing these rules.

The Committee also understands that certain arbitrary limitations placed on the operation of the indirect foreign tax credit may have resulted in taxpayers undergoing burdensome and sometimes costly corporate restructuring. In other cases, there is concern that these limitations may have contributed to decisions by U.S. companies against acquiring foreign subsidiaries. The Committee deems it appropriate to ease these restrictions.

Explanation of Provision

Lower-tier CFCs

Characterization of gain on stock disposition

Under the bill, if a CFC is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the CFC were a U.S. person. This provision, however, does not affect the determination of whether the corporation whose stock is sold or exchanged is a CFC.

Thus, for example, if a U.S. corporation owns 100 percent of the stock of a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, then under the bill, any gain of the first corporation upon a sale or exchange of stock of the second corporation is treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a CFC with respect to the U.S. shareholder.

Gain on disposition of stock in a related corporation created or organized under the laws of, and having a substantial part of its assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the proposal, is not excluded from foreign personal holding company income under the same-country exception that applies to actual dividends.

Under the bill, for purposes of this rule, a CFC is treated as having sold or exchanged stock if, under any provision of subtitle A of the Code, the CFC is treated as having gain from the sale or exchange of such stock. Thus, for example, if a CFC distributes to its shareholder stock in a foreign corporation, and the distribution results in gain being recognized by the CFC under section 311(b) as if the stock were sold to the shareholder for fair market value, the bill makes clear that, for purposes of this rule, the CFC is treated as having sold or exchanged the stock.

The bill also repeals a provision added to the Code by the Technical and Miscellaneous Revenue Act of 1988 that, except as provided by regulations, requires a recipient of a distribution from a CFC to have been a U.S. 10-percent shareholder of that CFC for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a 10/50 company. Thus, under the bill, a CFC is not treated as a 10/50 company with respect to any distribution out of its earnings and profits for periods during which it was a CFC, whether or not the recipient of the distribution was a U.S. 10-percent shareholder of the corporation when the earnings and profits giving rise to the distribution were generated.

Adjustments to basis of stock

Under the bill, when a lower-tier CFC earns subpart F income, and stock in that corporation is later disposed of by an upper-tier CFC, the resulting income inclusion of the U.S. 10-percent shareholders, under regulations, is to be adjusted to account for previous inclusions, in a manner similar to the adjustments provided to the basis of stock in a first-tier CFC. Thus, just as the basis of a U.S. 10-percent shareholder in a first-tier CFC rises when subpart F income is earned and falls when previously taxed income is distributed, so as to avoid double taxation of the income on a later disposition of the stock of that company, the subpart F income from gain on the disposition of a lower-tier CFC generally is reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier CFC.

For example, assume that a U.S. person is the owner of all of the stock of a first-tier CFC which, in turn, is the sole shareholder of a second-tier CFC. In year 1, the second-tier CFC earns $100 of subpart F income which is included in the U.S. person's gross income for that year. In year 2, the first-tier CFC disposes of the second-tier CFC's stock and recognizes $300 of income with respect to the disposition. All of that income constitutes subpart F foreign personal holding company income. Under the bill, the Secretary is granted regulatory authority to reduce the U.S. person's year 2 subpart F inclusion by $100—the amount of year 1 subpart F income of the second-tier CFC that was included, in that year, in the U.S. person's gross income. Such an adjustment, in effect, allows for a step-up in the basis of the stock of the second-tier CFC to the extent of its subpart F income previously included in the U.S. person's gross income.

Subpart F inclusions in year of acquisition

If a U.S. 10-percent shareholder acquires the stock of a CFC from another U.S. 10-percent shareholder during a taxable year of the CFC in which it earns subpart F income, the proposal reduces the acquiror's subpart F income inclusion for that year by a portion of the amount of the dividend deemed (under sec. 1248) to be received by the transferor. The portion by which the inclusion is reduced (as is the case if a dividend was paid to the previous owner of the stock) does not exceed the lesser of the amount of dividends with respect to such stock deemed received (under sec. 1248) by other persons during the year or the amount determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Treatment of U.S. income earned by a CFC

Under the bill, an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a CFC does not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income. For example, assume a CFC earns income of a type that generally would be subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S. branch profits tax under a provision of an applicable U.S. income tax treaty. The bill provides that, notwithstanding the treaty's effect on the branch tax, the income is not treated as subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

Extension of indirect foreign tax credit

The bill extends the application of the indirect foreign tax credit (secs. 902 and 960) to taxes paid or accrued by certain fourth-, fifth-, and sixth-tier foreign corporations. In general, three requirements are required to be satisfied by a foreign company at any of these tiers to qualify for the credit. First, the company must be a CFC. Second, the U.S. corporation claiming the credit under section 902(a) must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the foreign company. Third, the product of the percentage ownership of voting stock at each level from the U.S. corporation down must equal at least 5 percent. The bill limits the application of the indirect foreign tax credit below the third tier to taxes paid or incurred in taxable years during which the payor is a CFC. Foreign taxes paid below the sixth tier of foreign corporations remain ineligible for the indirect foreign tax credit.

Effective Dates

Lower-tier CFCs.—The provision that treats gains on dispositions of stock in lower-tier CFCs as dividends under section 1248 principles applies to gains recognized on transactions occurring after the date of enactment.

The provision that expands look-through treatment, for foreign tax credit limitation purposes, of dividends from CFCs is effective for distributions after the date of enactment.

The provision that provides for regulatory adjustments to U.S. shareholder inclusions, with respect to gains of CFCs from dispositions of stock in lower-tier CFCs is effective for determining inclusions for taxable years of U.S. shareholders beginning after December 31, 1997. Thus, the bill permits regulatory adjustments to an inclusion occurring after the effective date to account for income that was previously taxed under the subpart F provisions either prior to or subsequent to the effective date.

Subpart F inclusions in year of acquisition.—The provision that permits dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year is effective with respect to dispositions occurring after the date of enactment.

Treatment of U.S. source income earned by a CFC.—The provision concerning the effect of treaty exemptions from, or reductions of, the branch profits tax on the determination of subpart F income is effective for taxable years beginning after December 31, 1986.

Extension of indirect foreign tax credit.—The provision that extends application of the indirect foreign tax credit to certain CFCs below the third tier is effective for foreign taxes paid or incurred by CFCs for taxable years of such corporations beginning after the date of enactment.

In the case of any chain of foreign corporations, the taxes of which would be eligible for the indirect foreign tax credit, under present law or under the bill, but for the denial of indirect credits below the third or sixth tier, as the case may be, no liquidation, reorganization, or similar transaction in a taxable year beginning after the date of enactment will have the effect of permitting taxes to be taken into account under the indirect foreign tax credit provisions of the Code which could not have been taken into account under those provisions but for such transaction.

2. Simplify formation and operation of international joint ventures (secs. 921, 931–935, and 941 of the bill and secs. 367, 721, 1491–1494, 6031, 6038, 6038B, 6046A, and 6501 of the Code)

Present Law

Under section 1491, an excise tax generally is imposed on transfers of property by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital or to a foreign partnership, estate or trust. The tax is 35 percent of the amount of gain inherent in the property transferred but not recognized for income tax purposes at the time of the transfer. However, several exceptions to the section 1491 excise tax are available. Under section 1494(c), a substantial penalty applies in the case of a failure to report a transfer described in section 1491.

Section 367 applies to require gain recognition upon certain transfers by U.S. persons to foreign corporations. Under section 367(d), a U.S. person that contributes intangible property to a foreign corporation is treated as having sold the property to the corporation and is treated as receiving deemed royalty payments from the corporation. These deemed royalty payments are treated as U.S. source income. A U.S. person may elect to apply similar rules to a transfer of intangible property to a foreign partnership that otherwise would be subject to the section 1491 excise tax.

A foreign partnership may be required to file a partnership return. If a foreign partnership fails to file a required return, losses and credits with respect to the partnership may be disallowed to the partnership. A U.S. person that acquires or disposes of an interest in a foreign partnership, or whose proportional interest in the partnership changes substantially, may be required to file an information return with respect to such event.

A partnership generally is considered to be a domestic partnership if it is created or organized in the United States or under the laws of the United States or any State. A foreign partnership generally is any partnership that is not a domestic partnership.

Reasons for Change

The Committee understands that the present-law rules imposing an excise tax on certain transfers of appreciated property to a foreign entity unless the requirements for an exception from such excise tax are satisfied operate as a trap for the unwary. The Committee further understands that the special source rule of present law for deemed royalty payments with respect to a transfer of an appreciated intangible to a foreign corporation was intended to discourage such transfers. The Committee believes that the imposition of enhanced information reporting obligations with respect to both foreign partnerships and foreign corporations would eliminate the need for both of these sets of rules.

Explanation of Provision

The bill repeals the sections 1491–1494 excise tax and information reporting rules that apply to certain transfers of appreciated property by a U.S. person to a foreign entity. Instead of the excise tax that applies under present law to transfers to a foreign estate or trust, gain recognition is required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust. Instead of the excise tax that applies under present law to certain transfers to foreign corporations, regulatory authority is granted under section 367 to deny nonrecognition treatment to such a transfer in a transaction that is not otherwise described in section 367. Instead of the excise tax that applies under present law to transfers to foreign partnerships, regulatory authority is granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain otherwise would be transferred to a foreign partner. In addition, regulatory authority is granted to deny the nonrecognition treatment that is provided under section 1035 to certain exchanges of insurance policies, where the transfer is to a foreign person.

The bill repeals the rule that treats as U.S. source income any deemed royalty arising under section 367(d). Under the bill, in the case of a transfer of intangible property to a foreign corporation, the deemed royalty payments under section 367(d) are treated as foreign source income to the same extent that an actual royalty payment would be considered to be foreign source income. Regulatory authority is granted to provide similar treatment in the case of a transfer of intangible property to a foreign partnership.

The bill provides detailed information reporting rules in the case of foreign partnerships. A foreign partnership generally is required to file a partnership return for a taxable year if the partnership has U.S. source income or is engaged in a U.S. trade or business, except to the extent provided in regulations.

Under the bill, reporting rules similar to those applicable under present law in the case of controlled foreign corporations apply in the case of foreign partnerships. A U.S. partner that controls a foreign partnership is required to file an annual information return with respect to such partnership. For this purpose, a U.S. partner is considered to control a foreign partnership if the partner holds a more than 50 percent interest in the capital, profits, or, to the extent provided in regulations, losses, of the partnership. Similar information reporting also will be required from a U.S. 10-percent partner of a foreign partnership that is controlled by U.S. 10-percent partners. A $10,000 penalty applies to a failure to comply with these reporting requirements; additional penalties of up to $50,000 apply in the case of continued noncompliance after notification by the Secretary of the Treasury. Under the bill, the penalties for failure to report information with respect to a controlled foreign corporation are conformed with these penalties.

Under the bill, reporting by a U.S. person of an acquisition or disposition of an interest in a foreign partnership, or a change in the person's proportional interest in the partnership, is required only in the case of acquisitions, dispositions, or changes involving at least a 10-percent interest. A $10,000 penalty applies to a failure to comply with these reporting requirements; additional penalties of up to $50,000 apply in the case of continued noncompliance after notification by the Secretary. Under the bill, the penalties for failure to report information with respect to a foreign corporation are conformed with these penalties.

Under the bill, reporting rules similar to those applicable under present law in the case of transfers by U.S. persons to foreign corporations apply in the case of transfers to foreign partnerships. These reporting rules apply in the case of a transfer to a foreign partnership only if the U.S. person holds at least a 10-percent interest in the partnership or the value of the property transferred by such person to the partnership during a 12-month period exceeded $100,000. A penalty equal to 10 percent of the value of the property transferred applies to a failure to comply with these reporting requirements. Under the bill, the penalty under present law for failure to report transfers to a foreign corporation is conformed with this penalty. In the case of a transfer to a foreign partnership, failure to comply also results in gain recognition with respect to the property transferred.

Under the bill, in the case of a failure to report required information with respect to a foreign corporation, partnership, or trust, the statute of limitations with respect to any event or period to which such information relates not expire before the date that is three years after the date on which such information is provided.

Under the bill, regulatory authority is granted to provide rules treating a partnership as a domestic or foreign partnership, where such treatment is more appropriate, without regard to where the partnership is created or organized. It is expected that a recharterization of a partnership under such regulations will be based only on material factors such as the residence of the partners and the extent to which the partnership is engaged in business in the United States or earns U.S. source income. It also is expected that such regulations will provide guidance regarding the determination of whether an entity that is a partnership for Federal income tax purposes is to be considered to be created or organized in the United States or under the law of the United States or any State.

Effective Date

The provisions with respect to the repeal of sections 1491–1494 are effective upon date of enactment. The provisions with respect to the source of a deemed royalty under section 367(d) also are effective for transfers made and royalties deemed received after date of enactment.

The provisions regarding information reporting with respect to foreign partnerships generally are effective for partnership taxable years beginning after date of enactment. The provisions regarding information reporting with respect to interests in, and transfers to, foreign partnerships are effective for transfers to, and changes in interest in, foreign partnerships after date of enactment. Taxpayers may elect to apply these rules to transfers made after August 20, 1996 (and thereby avoid a penalty under section 1494(c)) and the Secretary may prescribe simplified reporting requirements for these cases. The provision with respect to the statute of limitations in the case of noncompliance with reporting requirements is effective for information returns due after date of enactment.

The provision granting regulatory authority with respect to the treatment of partnerships as foreign or domestic is effective for partnership taxable years beginning after date of enactment.

3. Modification of reporting threshold for stock ownership of a foreign corporation (sec. 936 of the bill and sec. 6046 of the Code)

Present Law

Several provisions of the Code require U.S. persons to report information with respect to a foreign corporation in which they are shareholders or officers or directors. Sections 6038 and 6035 generally require every U.S. citizen or resident who is an officer, or director, or who owns at least 10 percent of the stock, of a foreign corporation that is a controlled foreign corporation or a foreign personal holding company to file Form 5471 annually.

Section 6046 mandates the filing of information returns by certain U.S. persons with respect to a foreign corporation upon the occurrence of certain events. U.S. persons required to file these information returns are those who acquire 5 percent or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership.

A failure to file the required information return under section 6038 may result in monetary penalties or reduction of foreign tax credit benefits. A failure to file the required information returns under sections 6035 or 6046 may result in monetary penalties.

Reasons for Change

The Committee believes that it is appropriate to make the stock ownership threshold at which reporting with respect to an ownership interest in a foreign corporation is required generally parallel to the thresholds that apply in the case of other annual information reporting with respect to foreign corporations. The Committee believes that increasing the threshold for such reporting from 5 percent to 10 percent will reduce the compliance burdens on taxpayers.

Explanation of Provision

The bill increases the threshold for stock ownership of a foreign corporation that results in information reporting obligations under section 6046 from 5 percent (based on value) to 10 percent (based on vote or value).

Effective Date

The provision is effective for reportable transactions occurring after December 31, 1997.

4. Simplify translation of foreign taxes (sec. 902 of the bill and secs. 905(c) and 986 of the Code)

Present Law

Translation of foreign taxes

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession. This rule applies to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable in the year paid or accrued, and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation that is a shareholder of the foreign corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or has an income inclusion from the foreign corporation.

Redetermination of foreign taxes

For taxpayers that utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual. If a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination of foreign taxes arises. A foreign tax redetermination may occur in the case of a refund of foreign taxes. A foreign tax redetermination also may arise because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. In addition, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment.

As a general matter, a redetermination of foreign tax paid or accrued directly by a U.S. person requires notification of the Internal Revenue Service and a redetermination of U.S. tax liability for the taxable year for which the foreign tax was claimed as a credit. The Treasury regulations provide exceptions to this rule for de minimis cases. In the case of a redetermination of foreign taxes that qualify for the indirect (or "deemed-paid") foreign tax credit under sections 902 and 960, the Treasury regulations generally require taxpayers to make appropriate adjustments to the payor foreign corporation's pools of earnings and profits and foreign taxes.

Reasons for Change

The Committee believes that the administrative burdens associated with the foreign tax credit can be reduced significantly by permitting foreign taxes to be translated using reasonably accurate average translation rates for the period in which the tax payments are made. This approach will reduce, sometimes substantially, the number of translation calculations that are required to be made. In addition, the Committee believes that taxpayers that are on the accrual basis of accounting for purposes of determining creditable foreign taxes should be permitted to translate those taxes into U.S. dollar amounts in the year to which those taxes relate, and should not be required to make adjustments or redetermination to those translated amounts, if actual tax payments are made within a reasonably short period of time after the close of such year. Moreover, the Committee believes that it is appropriate to use an average exchange rate for the taxable year with respect to which such foreign taxes relate for purposes of translating those taxes. On the other hand, the Committee believes that a foreign tax not paid within a reasonably short period after the close of the year to which the taxes relate should not be treated as a foreign tax for such year. By drawing a bright line between those foreign tax payment delays that do and do not require a redetermination, the Committee believes that a reasonable degree of certainty and clarity will be added to the law in this area.

Explanation of Provision

Translation of foreign taxes

Translation of certain accrued foreign taxes

With respect to taxpayers that take foreign income taxes into account when accrued, the bill generally provides for foreign taxes to be translated at the average exchange rate for the taxable year to which such taxes relate. This rule does not apply (1) to any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to tax payments that are denominated in an inflationary currency (as defined by regulations).

Translation of all other foreign taxes

Under the bill, foreign taxes not eligible for application of the preceding rule generally are translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The bill provides the Secretary of the Treasury with authority to issue regulations that would allow foreign tax payments to be translated into U.S. dollar amounts using an average exchange rate for a specified period.

Redetermination of foreign taxes

Under the bill, a redetermination is required if: (1) accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, (2) accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, or (3) any tax paid is refunded in whole or in part. Thus, for example, the bill provides that if at the close of the second taxable year after the taxable year to which an accrued tax relates, any portion of the tax so accrued has not yet been paid, a foreign tax redetermination under section 905(c) is required for the amount representing the unpaid portion of that accrued tax. In other words, the previous accrual of any tax that is unpaid as of that date is denied. In cases where a redetermination is required, as under present law, the bill specifies that the taxpayer must notify the Secretary, who will redetermine the amount of the tax for the year or years affected. In the case of indirect foreign tax credits, regulatory authority is granted to prescribe appropriate adjustments to the foreign corporation's pool of post-1986 foreign income taxes in lieu of such a redetermination.

The bill provides specific rules for the treatment of accrued taxes that are paid more than two years after the close of the taxable year to which such taxes relate. In the case of the direct foreign tax credit, any such taxes subsequently paid are taken into account for the taxable year to which such taxes relate, but would be translated into U.S. dollar amounts using the exchange rates in effect as of the time such taxes are paid. In the case of the indirect foreign tax credit, any such taxes subsequently paid are taken into account for the taxable year in which paid, and would be translated into U.S. dollar amounts using the exchange rates as of the time such taxes are paid.

For example, assume that in year 1 a taxpayer accrues 1,000 units of foreign tax that relate to year 1 and that give rise to a foreign tax credit under section 901 and assume that the currency involved is not inflationary . Further assume that as of the end of year 1 the tax is unpaid. In this case, the bill provides that the taxpayer translates 1,000 units of accrued foreign tax into U.S. dollars at the average exchange rate for year 1. If the 1,000 units of tax are paid by the taxpayer in either year 2 or year 3, no redetermination of foreign tax is required. If any portion of the tax so accrued remains unpaid as of the end of year 3, however, the taxpayer is required to redetermine its foreign tax accrued in year 1 to eliminate the accrued but unpaid tax, thereby reducing its foreign tax credit for such year. If the taxpayer pays the disallowed taxes in year 4, the taxpayer again redetermines its foreign taxes (and foreign tax credit) for year 1, but the taxes paid in year 4 are translated into U.S. dollars at the exchange rate for year 4.

Effective Date

The provision generally is effective for foreign taxes paid (in the case of taxpayers using the cash basis for determining the foreign tax credit) or accrued (in the case of taxpayers using the accrual basis for determining the foreign tax credit) in taxable years beginning after December 31, 1997. The provision's changes to the foreign tax redetermination rules apply to foreign taxes which relate to taxable years beginning after December 31, 1997.

5. Election to use simplified foreign tax credit limitation for alternative minimum tax purposes (sec. 903 of the bill and sec. 59 of the Code)

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source income and items of U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, the allocation and apportionment of deductions must be done separately for regular tax foreign tax credit limitation purposes and AMT foreign tax credit limitation purposes.

Reasons for Change

The process of allocating and apportioning deductions for purposes of calculating the regular and AMT foreign tax credit limitations can be complex. Taxpayers that have allocated and apportioned deductions for regular tax purposes generally must reallocate and reapportion the same deductions for AMT foreign tax credit purposes, based on assets and income that reflect AMT adjustments (including depreciation). However, the differences between regular taxable income and alternative minimum taxable income often are relevant primarily to U.S. source income. The Committee believes that permitting taxpayers to use foreign source regular taxable income in computing their AMT foreign tax credit limitation would provide an appropriate simplification of the necessary computations by eliminating the need to reallocate and reapportion every deduction.

Explanation of Provision

The provision permits taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source alternative minimum taxable income to entire alternative minimum taxable income. Under this election, foreign source regular taxable income is used, however, only to the extent it does not exceed entire alternative minimum taxable income. In the event that foreign source regular taxable income does exceed entire alternative minimum taxable income, and the taxpayer has income in more than one foreign tax credit limitation category, the Committee intends that the foreign source taxable income in each such category generally would be reduced by a pro rata portion of that excess.

The election is available only in the first taxable year beginning after December 31, 1997 for which the taxpayer claims an AMT foreign tax credit. The Committee intends that a taxpayer will be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election, once made, will apply to all subsequent taxable years, and may be revoked only with the consent of the Secretary of the Treasury.

Effective Date

The provision applies to taxable years beginning after December 31, 1997.

6. Simplify stock and securities trading safe harbor (sec. 952 of the bill and sec. 864(b)(2)(A) of the Code)

Present Law

A nonresident alien individual or foreign corporation that is engaged in a trade or business within the United States is subject to U.S. taxation on its net income that is effectively connected with the trade or business, at graduated rates of tax. Under a "safe harbor" rule, foreign persons that trade in stocks or securities for their own accounts are not treated as engaged in a U.S. trade or business for this purpose.

For a foreign corporation to qualify for the safe harbor, it must not be a dealer in stock or securities. In addition, if the principal business of the foreign corporation is trading in stock or securities for its own account, the safe harbor generally does not apply if the principal office of the corporation is in the United States.

For foreign persons who invest in securities trading partnerships, the safe harbor applies only if the partnership is not a dealer in stock and securities. In addition, if the principal business of the partnership is trading stock or securities for its own account, the safe harbor generally does not apply if the principal office of the partnership is in the United States.

Under Treasury regulations which apply to both corporations and partnerships, the determination of the location of the entity's principal office turns on the location of various functions relating to operation of the entity, including communication with investors and the general public, solicitation and acceptance of sales of interests, and maintenance and audits of its books of account (Treas. reg. sec. 1.864-2(c)(2)(ii) and (iii)). Under the regulations, the location of the entity's principal office does not depend on the location of the entity's management or where investment decisions are made.

Reasons for Change

The foreign principal office requirement does not promote any important tax policy and has been easily circumvented. The stock and securities trading safe harbor serves to promote foreign investment in U.S. capital markets. The Committee believes that the elimination of the principal office rule would facilitate foreign investment in U.S. markets. Because the location of a partnership's or foreign corporation's principal office is determined by the location of certain administrative functions rather than the location of management and investment decisions, the requirement of a foreign principal office is met even if only administrative functions are performed abroad.

Explanation of Provision

The bill modifies the stock and securities trading safe harbor by eliminating the requirement for both partnerships and foreign corporations that trade stock or securities for their own accounts that the entity's principal office not be within the United States.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

7. Simplify foreign tax credit limitation for individuals (sec. 901 of the bill and sec. 904 of the Code)

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments. Taxable income of this type ordinarily is includible in the single foreign tax credit limitation category for passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in one of several other separate limitation categories (e.g., high withholding tax interest income or general limitation income). For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Reasons for Change

The Committee believes that a significant number of individuals are entitled to credit relatively small amounts of foreign tax imposed at modest effective tax rates on foreign source investment income. For taxpayers in this class, the applicable foreign tax credit limitations typically exceed the amounts of taxes paid. Therefore, exempting these taxpayers from the foreign tax credit limitation rules significantly reduces the complexity of the tax law without significantly altering actual tax liabilities. At the same time, however, the Committee believes that this exemption should be limited to those cases where the taxpayer receives a payee statement showing the amount of the foreign source income and the foreign tax.

Explanation of Provision

The bill allows individuals with no more than $300 ($600 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than passive income, an exemption from the foreign tax credit limitation rules. (The Committee intends that an individual electing this exemption will not be required to file Form 1116 in order to obtain the benefit of the foreign tax credit.) An individual making this election is not entitled to any carryover of excess foreign taxes to or from a taxable year to which the election applies.

For purposes of this election, passive income generally is defined to include all types of income that is foreign personal holding company income under the subpart F rules, plus income inclusions from foreign personal holding companies and passive foreign investment companies, provided that the income is shown on a payee statement furnished to the individual. For purposes of this election, creditable foreign taxes include only foreign taxes that are shown on a payee statement furnished to the individual.

Effective Date

The provision applies to taxable years beginning after December 31, 1997.

8. Simplify treatment of personal transactions in foreign currency (sec. 904 of the bill and sec. 988 of the Code)

Present Law

When a U.S. taxpayer makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") generally arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss also can arise where foreign currency was acquired for personal use. For example, the IRS has ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use while traveling abroad realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency (Rev. Rul. 74–7, 1974–1 C.B. 198).

Prior to the Tax Reform Act of 1986 ("1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the IRS. Additional rules of limited application were provided by Treasury regulations. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The 1986 Act provided a comprehensive set of rules for the U.S. tax treatment of transactions involving foreign currencies.

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988 of the Code, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions are deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.

Reasons for Change

An individual who lives or travels abroad generally cannot use U.S. dollars to make all of the purchases incident to daily life. If an individual must treat foreign currency in this instance as property giving rise to U.S.-dollar income or loss every time the individual, in effect, "barters" the foreign currency for goods or services, the U.S. individual living in or visiting a foreign country will have a significant administrative burden that may bear little or no relation to whether U.S.-dollar measured income has increased or decreased. The Committee believes that individuals should be given relief from the requirement to keep track of exchange gains on a transaction-by-transaction basis in de minimis cases.

Explanation of Provision

If an individual acquires foreign currency and disposes of it in a personal transaction and the exchange rate changes between the acquisition and disposition of such currency, the provision applies nonrecognition treatment to any resulting exchange gain, provided that such gain does not exceed $200. The provision does not change the treatment of resulting exchange losses. The Committee understands that under other Code provisions such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The provision applies to taxable years beginning after December 31, 1997.

9. Transition rule for certain trusts (sec. 951 of the bill and sec. 7701(a)(30) of the Code)

Present Law

Under rules enacted with the Small Business Job Protection Act of 1996, a trust is considered to be a U.S. trust if two criteria are met. First, a court within the United States must be able to exercise primary supervision over the administration of the trust. Second, U.S. fiduciaries of the trust must have the authority to control all substantial decisions of the trust. A trust that does not satisfy both of these criteria is considered to be a foreign trust. These rules for defining a U.S. trust generally are effective for taxable years of a trust that begin after December 31, 1996. A trust that qualified as a U.S. trust under prior law could fail to qualify as a U.S. trust under these new criteria.

Reasons for Change

The change in the criteria for qualification as a U.S. trust could cause large numbers of existing domestic trusts to become foreign trusts, unless they are able to make the modifications necessary to satisfy the new criteria. The Committee believes that an election is appropriate for those existing domestic trusts that prefer to continue to be subject to tax as U.S. trusts.

Explanation of Provision

Under the bill, the Secretary of the Treasury is granted authority to allow nongrantor trusts that had been treated as U.S. trusts under prior law to elect to continue to be treated as U.S. trusts, notwithstanding the new criteria for qualification as a U.S. trust.

Effective Date

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

10. Clarification of determination of foreign taxes deemed paid (sec. 953(a) of the bill and sec. 902 of the Code)

Present Law

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of such dividend to the foreign corporation's post-1986 undistributed earnings. The foreign corporation's post-1986 foreign income taxes is the sum of the foreign income taxes with respect to the taxable year in which the dividend is distributed plus certain foreign income taxes with respect to prior taxable years (beginning after December 31, 1986).

Reasons for Change

The Committee believes that it is appropriate to clarify the determination of foreign taxes deemed paid for purposes of the indirect foreign tax credit.

Explanation of Provision

The bill clarifies that, for purposes of the deemed paid credit under section 902 for a taxable year, a foreign corporation's post-1986 foreign income taxes includes foreign income taxes with respect to prior taxable years (beginning after December 31, 1986) only to the extent such taxes are not attributable to dividends distributed by the foreign corporation in prior taxable years. No inference is intended regarding the determination of foreign taxes deemed paid under present law.

Effective Date

The provision is effective on date of enactment.

11. Clarification of foreign tax credit limitation for financial services income (sec. 953(b) of the bill and sec. 904 of the Code)

Present Law

Under section 904, separate foreign tax credit limitations apply to various categories of income. Two of these separate limitation categories are passive income and financial services income. For purposes of the separate foreign tax credit limitation applicable to passive income, certain income that is treated as high-taxed income is excluded from the definition of passive income. For purposes of the separate foreign tax credit limitation applicable to financial services income, the definition of financial services income generally incorporates passive income as defined for purposes of the separate limitation applicable to passive income.

Reasons for Change

The Committee believes that it is appropriate to clarify that high-taxed income is not excluded from the separate foreign tax credit limitation for financial services income.

Explanation of Provision

The bill clarifies that the exclusion of income that is treated as high-taxed income does not apply for purposes of the separate foreign tax credit limitation applicable to financial services income. No inference is intended regarding the treatment of high-taxed income for purposes of the separate foreign tax credit limitation applicable to financial services income under present law.

Effective Date

The provision is effective on date of enactment.

TITLE X. SIMPLIFICATION PROVISIONS RELATING TO INDIVIDUALS AND BUSINESSES

A. Provisions Relating to Individuals

1. Modifications to standard deduction of dependents; AMT treatment of certain minor children (sec. 1001 of the bill and secs. 59(j) and 63(c)(5) of the Code)

Present Law

Standard deduction of dependents.—The standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return can not exceed the lesser of (1) the standard deduction for an individual taxpayer (projected to be $4,250 for 1998) or (2) the greater of $500 (indexed)[121] or the dependent's earned income (sec. 63(c)(5)).

Taxation of unearned income of children under age 14.—The tax on a portion of the unearned income (e.g., interest and dividends) of a child under age 14 is the additional tax that the child's custodial parent would pay if the child's unearned income were included in that parent's income. The portion of the child's unearned income which is taxed at the parent's top marginal rate is the amount by which the child's unearned income is more than the sum of (1) $500[122] (indexed) plus (2) the greater of (a) $500[123] (indexed) or (b) the child's itemized deductions directly connected with the production of the unearned income (sec. 1(g)).

Alternative minimum tax ("AMT") exemption for children under age 14.—Single taxpayers are entitled to an exemption from the alternative minimum tax ("AMT") of $33,750. However, in the case of a child under age 14, his exemption from the AMT, in substance, is the unused alternative minimum tax exemption of the child's custodial parent, limited to sum of earned income and $1,400 (sec. 59(j)).

Reasons for Change

The committee believes that significant simplification of the existing income tax system can be achieved by providing larger exemptions such that taxpayers with incomes less than the exemption are not required to compute and pay any tax. The committee particularly believes that the present-law exemptions of dependent children are too small.

Explanation of Provision

Standard deduction of dependents.—The bill increases the standard deduction for a taxpayer with respect to whom a dependency exemption is allowed on another taxpayer's return to the lesser of (1) the standard deduction for individual taxpayers or (2) the greater of: (a) $500[124] (indexed for inflation as under present law), or

[121] The indexed amount is projected to be $700 for 1998.
[122] Projected to be $700 for 1998.
[123] Projected to be $700 for 1998.
[124] Projected to be $700 for 1998.

(b) the individual's earned income plus $250. The $250 amount is indexed for inflation after 1998.

Alternative minimum tax exemption for children under age 14.— The bill increases the AMT exemption amount for a child under age 14 to the lesser of (1) $33,750 or (2) the sum of the child's earned income plus $5,000. The $5,000 amount is indexed for inflation after 1998.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

2. Increase de minimis threshold for estimated tax to $1,000 for individuals (sec. 1002 of the bill and sec. 6654 of the Code)

Present Law

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax (sec. 6654). An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax shown on the return of the individual for the preceding year (the "100 percent of last year's liability safe harbor") or (2) 90 percent of the tax shown on the return for the current year. The 100 percent of last year's liability safe harbor is modified to be a 110 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year. Income tax withholding from wages is considered to be a payment of estimated taxes. In general, payment of estimated taxes must be made quarterly. The addition to tax is not imposed where the total tax liability for the year, reduced by any withheld tax and estimated tax payments, is less than $500.

Reasons for Change

Raising the individual estimated tax de minimis threshold will simplify the tax laws for a number of taxpayers.

Explanation of Provision

The bill increases the $500 individual estimated tax de minimis threshold to $1,000.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

3. Treatment of certain reimbursed expenses of rural letter carriers' vehicles (sec. 1003 of the bill and sec. 162 of the Code)

Present Law

A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and maintenance expenses of the vehicle, plus depreciation (subject to the limitations of sec. 280F). Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

An employee of the U.S. Postal Service may compute his deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route by using, for all business use mileage, 150 percent of the standard mileage rate.

Rural letter carriers are paid an equipment maintenance allowance (EMA) to compensate them for the use of their personal automobiles in delivering the mail. The tax consequences of the EMA are determined by comparing it with the automobile expense deductions that each carrier is allowed to claim (using either the actual expenses method or the 150 percent of the standard mileage rate). If the EMA exceeds the allowable automobile expense deductions, the excess generally is subject to tax. If the EMA falls short of the allowable automobile expense deductions, a deduction is allowed only to the extent that the sum of this shortfall and all other miscellaneous itemized deductions exceeds two percent of the taxpayer's adjusted gross income.

Reasons for Change

The filing of tax returns by rural letter carriers can be complex. Under present law, those who are reimbursed at more than the 150 percent rate must report their reimbursement as income and deduct their expenses as miscellaneous itemized deductions (subject to the two-percent floor). Permitting the income and expenses to wash, so that neither will have to be reported on the rural letter carrier's tax return, will simplify these tax returns.

Explanation of Provision

The bill repeals the special rate for Postal Service employees of 150 percent of the standard mileage rate. In its place, the bill requires that the rate of reimbursement provided by the Postal Service to rural letter carriers be considered to be equivalent to their expenses. The rate of reimbursement that is considered to be equivalent to their expenses is the rate of reimbursement contained in the 1991 collective bargaining agreement, which may be increased by no more than the rate of inflation.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

4. Travel expenses of Federal employees participating in a Federal criminal investigation (sec. 1004 of the bill and sec. 162 of the Code)

Present Law

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the two-percent floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment (sec. 162(a)). If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

Reasons for Change

The Committee believes that it would be inappropriate if this provision in the tax laws were to be a hindrance to the investigation of a Federal crime.

Explanation of Provision

The one-year limitation with respect to deductibility of expenses while temporarily away from home does not include any period during which a Federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the Federal Government in a temporary duty status to investigate or provide support services to the investigation of a Federal crime. Thus, expenses for these individuals during these periods are fully deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

Effective Date

The provision is effective for amounts paid or incurred with respect to taxable years ending after the date of enactment.

B. Provisions Relating to Businesses Generally

1. Modifications to look-back method for long-term contracts (sec. 1011 of the bill and secs. 460 and 167(g) of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[125] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of (1) $1 million or (2) one percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method.

[125] The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use the different interests rates.

Reasons for Change

Present law may require multiple applications of the look-back method with respect to a single contract or may otherwise subject contracts to the look-back method even though amounts necessitating the look-back calculations are de minimis relative to the aggregate contract income. In addition, the use of multiple interest rates complicates the mechanics of the look-back calculation. The committee wishes to address these concerns.

Explanation of Provision

Election not to apply the look-back method for de minimis amounts

The provision provides that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but is not required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 1.—A taxpayer enters into a three-year contract and upon completion of the contract, determines that annual net income under the contract using actual contract price and costs is \$100,000, \$150,000, and \$250,000, respectively, for Years 1, 2, and 3 under the percentage of completion method. An electing taxpayer need not apply the look-back method to the contract if it had reported cumulative net taxable income under the contract using estimated contract price and costs of between \$90,000 and \$110,000 as of the end of Year 1; and between \$225,000 and \$275,000 as of the end of Year 2.

Election not to reapply the look-back method

The provision provides that a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract are not discounted.

Thus, an electing taxpayer need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 2.—A taxpayer enters into a three-year contract and reports taxable income of $12,250, $15,000 and $12,750, respectively, for Years 1 through 3 with respect to the contract. Upon completion of the contract, cumulative look-back income with respect to the contract is $40,000, and 10 percent of such amount is $4,000. After the completion of the contract, the taxpayer incurs additional costs of $2,500 in each of the next three succeeding years (Years 4, 5, and 6) with respect to the contract. Under the provision, an electing taxpayer does not reapply the look-back method for Year 4 because the cumulative amount of contract taxable income ($37,500) is within 10 percent of contract look-back income as of the completion of the contract ($40,000). However, the look-back method must be applied for Year 5 because the cumulative amount of contract taxable income ($35,000) is not within 10 percent of contract look-back income as of the completion of the contract ($40,000). Finally, the taxpayer does not reapply the look-back method for Year 6 because the cumulative amount of contract taxable income ($32,500) is within 10 percent of contract look-back income as of the last application of the look-back method ($35,000).

Interest rates used for purposes of the look-back method

The provision provides that for purposes of the look-back method, only one rate of interest is to apply for each accrual period. An accrual period with respect to a taxable year begins on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins.

Effective Date

The provision applies to contracts completed in taxable years ending after the date of enactment. The change in the interest rate calculation also applies for purposes of the look-back method applicable to the income forecast method of depreciation for property placed in service after September 13, 1995.

2. Minimum tax treatment of certain property and casualty insurance companies (sec. 1012 of the bill and sec. 56(g)(4)(B) of the Code)

Present Law

Present law provides that certain property and casualty insurance companies may elect to be taxed only on taxable investment income for regular tax purposes (sec. 831(b)). Eligible property and casualty insurance companies are those whose net written premiums (or if greater, direct written premiums) for the taxable year exceed $350,000 but do not exceed $1,200,000.

Under present law, all corporations including insurance companies are subject to an alternative minimum tax. Alternative minimum taxable income is increased by 75 percent of the excess of adjusted current earnings over alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses).

Reasons for Change

The Committee believes that property and casualty companies small enough to be eligible to simplify their regular tax computation by electing to be taxed only on taxable investment income should be accorded comparable simplicity in the calculation of their alternative minimum tax. Under present law, the simplicity under the regular tax is nullified because electing companies must calculate underwriting income for tax purposes under the alternative minimum tax. The provision thus simplifies the entire Federal income tax calculation for a group of small taxpayers whom Congress has previously determined merit a simpler tax calculation.

Explanation of Provision

The provision provides that a property and casualty insurance company that elects for regular tax purposes to be taxed only on taxable investment income determines its adjusted current earnings under the alternative minimum tax without regard to any amount not taken into account in determining its gross investment income under section 834(b). Thus, adjusted current earnings of an electing company is determined without regard to underwriting income (or underwriting expense, as provided in sec. 56(g)(4)(B)(i)(II)).

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

3. Shrinkage for inventory accounting (sec. 1013 of the bill and sec. 471 of the Code)

Present Law

Section 471(a) provides that "(w)henever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income." Where a taxpayer maintains book inventories in accordance with a sound accounting system, the net value of the inventory will be deemed to be the cost basis of the inventory, provided that such book inventories are verified by physical inventories at reasonable intervals and adjusted to conform therewith.[126] The physical count is used to determine and adjust for certain items, such as undetected theft, breakage, and bookkeeping errors, collectively referred to as "shrinkage."

Some taxpayers verify and adjust their book inventories by a physical count taken on the last day of the taxable year. Other taxpayers may verify and adjust their inventories by physical counts taken at other times during the year. Still other taxpayers take physical counts at different locations at different times during the taxable year (cycle counting).

If a physical inventory is taken at year-end, the amount of shrinkage for the year is known. If a physical inventory is not taken at year-end, shrinkage through year-end will have to be based on an estimate, or not taken into account until the following year. In the first decision in *Dayton Hudson* v. *Commissioner*,[127] the U.S. Tax Court held that a taxpayer's method of accounting may include the use of an estimate of shrinkage occurring through year-end, provided the method is sound and clearly reflects income. In the second decision in *Dayton Hudson* v. *Commissioner,*[128] the U.S. Tax Court adhered to this holding. However, the U.S. Tax Court in the second decision determined that this taxpayer had not established that its method of accounting clearly reflected income. Other cases decided by the U.S. Tax Court[129] have held that taxpayers' methods of accounting that included shrinkage estimates do clearly reflect income.

The U.S. Tax Court in the second *Dayton Hudson* opinion noted that "(I)n most cases, generally accepted accounting principles (GAAP), consistently applied, will pass muster for tax purposes. The Supreme Court has made clear, however, that GAAP does not enjoy a presumption of accuracy that must be rebutted by the Commissioner."

Reasons for Change

The Committee believes that inventories should be kept in a manner that clearly reflects income. The Committee also believes that it is inappropriate to require a physical count of a taxpayer's entire inventory to be taken exactly at year-end, provided that physical counts are taken on a regular and consistent basis. Where physical inventories are not taken at year-end, the Committee believes that income will be more clearly reflected if the taxpayer makes a reasonable estimate of the shrinkage occurring through year-end, rather than simply ignoring it.

The Committee believes that a taxpayer should have the opportunity to change its method of accounting to a method that keeps inventories using shrinkage estimates, so long as such method is sound and clearly reflects income. The Committee does not believe that it is appropriate to deny a taxpayer access to such a method solely because its current, acceptable method of accounting does not utilize shrinkage estimates.

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[126] Treas. reg. sec. 1.471–2(d).
[127] 101 T.C. 462 (1993).
[128] T.C. Memo (filed June 11, 1997).
[129] *Wal-Mart* v. *Commissioner,* T.C. Memo 1997–1 and *Kroger* v. *Commissioner,* T.C. Memo 1997–2.

Explanation of Provision

The bill provides that a method of keeping inventories will not be considered unsound, or to fail to clearly reflect income, solely because it includes an adjustment for the shrinkage estimated to occur through year-end, based on inventories taken other than at year-end. Such an estimate must be based on actual physical counts. Where such an estimate is used in determining ending inventory balances, the taxpayer is required to take a physical count of inventories at each location on a regular and consistent basis. A taxpayer is required to adjust its ending inventory to take into account all physical counts performed through the end of its taxable year.

Effective Date

The provision is effective for taxable years ending after the date of enactment.

A taxpayer is permitted to change its method of accounting by this section if the taxpayer is currently using a method that does not utilize estimates of inventory shrinkage and wishes to change to a method for inventories that includes shrinkage estimates based on physical inventories taken other than at year-end. Such a change is treated as a voluntary change in method of accounting, initiated by the taxpayer with the consent of the Secretary of the Treasury, provided the taxpayer changes to a permissible method of accounting. The period for taking into account any adjustment required under section 481 as a result of such a change in method is 4 years.

No inference is intended by the Committee by the adoption of this provision with regard to whether any particular method of accounting for inventories is permissible under present law.

4. Treatment of construction allowances provided to lessees (sec. 1014 of the bill and new sec. 110 of the Code)

Present Law

Depreciation allowances for property used in a trade or business generally are determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).[130] This rule applies whether the lessor or lessee places the leasehold improvements in service.[131] If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in

[130] The Tax Reform Act of 1986 modified the Accelerated Cost Recovery System ("ACRS") to institute MACRS. Prior to the adoption of ACRS by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The denial of component depreciation also applies under MACRS, as provided by the Tax Reform Act of 1986.

[131] Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

the month the addition or improvement was placed in service (secs. 168 (b)(3), (c)(1), (d)(2), and (l)(6)). A lessor of leased property that disposes of a leasehold improvement that was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease (sec. 168(i)(8)).

The gross income of a lessor of real property does not include any amount attributable to the value of buildings erected, or other improvements made by, a lessee that revert to the lessor at the termination of a lease (sec. 109).

Issues have arisen as to the proper treatment of amounts provided to a lessee by a lessor for property to be constructed and used by the lessee pursuant to the lease ("construction allowances"). In general, incentive payments are includible in income as accessions to wealth.[132] A coordinated issue paper issued by the Internal Revenue Service ("IRS") on October 7, 1996, states the IRS position that construction allowances should generally be included in income in the year received. However, the paper does recognize that amounts received by a lessee from a lessor and expended by the lessee on assets owned by the lessor were not includible in the lessee's income. The issue paper provides that tax ownership is determined by applying a "benefits and burdens of ownership" test that includes an examination of the following factors: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract creates present obligations on the seller to execute and deliver a deed and on the buyer to make payments; (5) whether the right of possession is vested; (6) who pays property taxes; (7) who bears the risk of loss or damage to the property; (8) who receives the profits from the operation and sale of the property; (9) who carries insurance with respect to the property; (9) who is responsible for replacing the property; and (10) who has the benefits of any remainder interests in the property.

Reasons for Change

The committee understands that it is common industry practice for a lessor to custom improve retail space for the use by a lessee pursuant to a lease. Such leasehold improvements may be provided by the lessor directly constructing the improvements to the lessee's specifications. Alternatively, the lessee may receive a construction allowance from the lessor pursuant to the lease in order for the lessee to build or improve the property. The committee believes that the tax treatment of lessors and lessees in either case should be the same. The committee understands that the IRS issue paper reaches a similar conclusion in cases where the lessor is treated as the tax owner of the constructed or improved property. However, the committee is concerned that the traditional factors cited by the IRS in making the determination of who is the tax owner of the property may be applied differently by the lessor and the lessee and may lead to controversies between the IRS and taxpayers.

[132] *John B. White, Inc.* v. *Comm.,* 55 T.C. 729 (1971), aff'd per curiam 458 F. 2d 989 (3d Cir.), cert. denied, 409 U.S. 876 (1972).

Thus, the bill provides, in effect, a safe harbor such that it will be assumed that a construction allowance is used to construct or improve lessor property (and is properly excludible by the lessee) when long-lived property is constructed or improved and used pursuant to a short-term lease. In addition, the bill provides safeguards to ensure that lessors and lessees consistently treat the property subject to the construction allowance as nonresidential real property.

Explanation of Provision

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

The bill provides that the lessor must treat the amounts expended on the construction allowance as nonresidential real property owned by the lessor. However, the lessee's exclusion is not dependent upon the lessor's treatment of the property as nonresidential real property.

The bill contains reporting requirements to ensure that both the lessor and lessee treat such amounts consistently as nonresidential real property. Under regulations, the lessor and the lessee shall, at such times and in such manner as provided by the regulations, furnish to the Secretary of the Treasury information concerning the amounts received (or treated as a rent reduction), the amounts expended on qualified long-term real property, and such other information as the Secretary deems necessary to carry out the provisions of the bill. It is expected that the Secretary, in promulgating such regulations, will attempt to minimize the administrative burdens of taxpayers while ensuring compliance with the bill.

Effective Date

The provision applies to leases entered into after the date of enactment. No inference is intended as to the treatment of amounts that are not subject to the provision.

C. Partnership Simplification Provisions

1. General provisions

a. Simplified flow-through for electing large partnerships (sec. 1021 of the bill and new secs. 771-777 of the Code)

Present Law

Treatment of partnerships in general

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

The taxable income of a partnership is computed in the same manner as that of an individual, except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived from a partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

Capital gains

The net capital gain of an individual is taxed generally at the same rates applicable to ordinary income, subject to a maximum marginal rate of 28 percent. Net capital gain is the excess of net long-term capital gain over net short-term capital loss. Individuals with a net capital loss generally may deduct up to $3,000 of the loss each year against ordinary income. Net capital losses in excess of the $3,000 limit may be carried forward indefinitely.

A special rule applies to gains and losses on the sale, exchange or involuntary conversion of certain trade or business assets (sec. 1231). In general, net gains from such assets are treated as long-term capital gains but net losses are treated as ordinary losses.

A partner's share of a partnership's net short-term capital gain or loss and net long-term capital gain or loss from portfolio investments is separately reported to the partner. A partner's share of a partnership's net gain or loss under section 1231 generally is also separately reported.

Deductions and credits

Miscellaneous itemized deductions (e.g., certain investment expenses) are deductible only to the extent that, in the aggregate, they exceed two percent of the individual's adjusted gross income.

In general, taxpayers are allowed a deduction for charitable contributions, subject to certain limitations. The deduction allowed an individual generally cannot exceed 50 percent of the individual's adjusted gross income for the taxable year. The deduction allowed a corporation generally cannot exceed 10 percent of the corporation's taxable income. Excess contributions are carried forward for five years.

A partner's distributive share of a partnership's miscellaneous itemized deductions and charitable contributions is separately reported to the partner.

Each partner is allowed his distributive share of credits against his taxable income.

Foreign taxes

The foreign tax credit generally allows U.S. taxpayers to reduce U.S. income tax on foreign income by the amount of foreign income taxes paid or accrued with respect to that income. In lieu of electing the foreign tax credit, a taxpayer may deduct foreign taxes. The total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year.

Unrelated business taxable income

Tax-exempt organizations are subject to tax on income from unrelated businesses. Certain types of income (such as dividends, interest and certain rental income) are not treated as unrelated business taxable income. Thus, for a partner that is an exempt organization, whether partnership income is unrelated business taxable income depends on the character of the underlying income. Income from a publicly traded partnership, however, is treated as unrelated business taxable income regardless of the character of the underlying income.

Special rules related to oil and gas activities

Taxpayers involved in the search for and extraction of crude oil and natural gas are subject to certain special tax rules. As a result, in the case of partnerships engaged in such activities, certain specific information is separately reported to partners.

A taxpayer who owns an economic interest in a producing deposit of natural resources (including crude oil and natural gas) is permitted to claim a deduction for depletion of the deposit as the minerals are extracted. In the case of oil and gas produced in the United States, a taxpayer generally is permitted to claim the greater of a deduction for cost depletion or percentage depletion. Cost depletion is computed by multiplying a taxpayer's adjusted basis in the depletable property by a fraction, the numerator of which is the amount of current year production from the property and the denominator of which is the property's estimated reserves as of the beginning of that year. Percentage depletion is equal to a specified percentage (generally, 15 percent in the case of oil and gas) of gross income from production. Cost depletion is limited to the taxpayer's basis in the depletable property; percentage depletion is not so limited. Once a taxpayer has exhausted its basis in the depletable property, it may continue to claim percentage depletion deductions (generally referred to as "excess percentage depletion").

Certain limitations apply to the deduction for oil and gas percentage depletion. First, percentage depletion is not available to oil and gas producers who also engage (directly or indirectly) in significant levels of oil and gas retailing or refining activities (so-called "integrated producers" of oil and gas). Second, the deduction for percentage depletion may be claimed by a taxpayer only with respect to up to 1,000 barrels-per-day of production. Third, the percentage depletion deduction may not exceed 100 percent of the taxpayer's net income for the taxable year from the depletable oil and gas property. Fourth, a percentage depletion deduction may not be claimed to the extent that it exceeds 65 percent of the taxpayer's pre-percentage depletion taxable income.

In the case of a partnership that owns depletable oil and gas properties, the depletion allowance is computed separately by the partners and not by the partnership. In computing a partner's basis in his partnership interest, basis is increased by the partner's share of any partnership-related excess percentage depletion deductions and is decreased (but not below zero) by the partner's total amount of depletion deductions attributable to partnership property.

Intangible drilling and development costs ("IDCs") incurred with respect to domestic oil and gas wells generally may be deducted at the election of the taxpayer. In the case of integrated producers, no more than 70 percent of IDCs incurred during a taxable year may be deducted. IDCs not deducted are capitalized and generally are either added to the property's basis and recovered through depletion deductions or amortized on a straight-line basis over a 60-month period.

The special treatment granted to IDCs incurred in the pursuit of oil and gas may give rise to an item of tax preference or (in the case of corporate taxpayers) an adjusted current earnings ("ACE") adjustment for the alternative minimum tax. The tax preference item is based on a concept of "excess IDCs." In general, excess IDCs are the excess of IDCs deducted for the taxable year over the amount of those IDCs that would have been deducted had they been capitalized and amortized on a straight-line basis over 120 months commencing with the month production begins from the related well. The amount of tax preference is then computed as the difference between the excess IDC amount and 65 percent of the taxpayer's net income from oil and gas (computed without a deduction for excess IDCs). For IDCs incurred in taxable years beginning after 1992, the ACE adjustment related to IDCs is repealed for taxpayers other than integrated producers. Moreover, beginning in 1993, the IDC tax preference generally is repealed for taxpayers other than integrated producers. In this case, however, the repeal of the excess IDC preference may not result in more than a 40 percent reduction (30 percent for taxable years beginning in 1993) in the amount of the taxpayer's alternative minimum taxable income computed as if that preference had not been repealed.

Passive losses

The passive loss rules generally disallow deductions and credits from passive activities to the extent they exceed income from passive activities. Losses not allowed in a taxable year are suspended and treated as current deductions from passive activities in the next taxable year. These losses are allowed in full when a taxpayer disposes of the entire interest in the passive activity to an unrelated person in a taxable transaction. Passive activities include trade or business activities in which the taxpayer does not materially participate. (Limited partners generally do not materially participate in the activities of a partnership.) Passive activities also include rental activities (regardless of the taxpayer's material participation).[133] Portfolio income (such as interest and dividends), and expenses allocable to such income, are not treated as income or loss from a passive activity.

The $25,000 allowance also applies to low-income housing and rehabilitation credits (on a deduction equivalent basis), regardless of whether the taxpayer claiming the credit actively participates in the rental real estate activity generating the credit. In addition, the income phaseout range for the $25,000 allowance for rehabilitation credits is $200,000 to $250,000 (rather than $100,000 to $150,000). For interests acquired after December 31, 1989 in partnerships holding property placed in service after that date, the $25,000 deduction-equivalent allowance is permitted for the low-income housing credit without regard to the taxpayer's income.

A partnership's operations may be treated as multiple activities for purposes of the passive loss rules. In such case, the partnership must separately report items of income and deductions from each of its activities.

Income, loss and other items from a publicly traded partnership are treated as separate from income and loss from any other publicly traded partnership, and also as separate from any income or loss from passive activities.

The Omnibus Budget Reconciliation Act of 1993 added a rule, effective for taxable years beginning after December 31, 1993, treating a taxpayer's rental real estate activities in which he materially participates as not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which he performs services (sec. 469(c)(7)). Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. An individual taxpayer generally meets the eligibility requirements if (1) more than half of the personal services the taxpayer performs in trades or business during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

REMICs

A tax is imposed on partnerships holding a residual interest in a real estate mortgage investment conduit ("REMIC"). The amount of the tax is the amount of excess inclusions allocable to partnership interests owned by certain tax-exempt organizations ("dis-

[133] An individual who actively participates in a rental real estate activity and holds at least a 10-percent interest may deduct up to $25,000 of passive losses. The $25,000 amount phases out as the individual's income increases from $100,000 to $150,000.

qualified organizations") multiplied by the highest corporate tax rate.

Contribution of property to a partnership

In general, a partner recognizes no gain or loss upon the contribution of property to a partnership. However, income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be allocated among the partners so as to take into account the difference between the basis of the property to the partnership and its fair market value at the time of contribution. In addition, the contributing partner must recognize gain or loss equal to such difference if the property is distributed to another partner within five years of its contribution (sec. 704(c)), or if other property is distributed to the contributor within the five year period (sec. 737).

Election of optional basis adjustments

In general, the transfer of a partnership interest or a distribution of partnership property does not affect the basis of partnership assets. A partnership, however, may elect to make certain adjustments in the basis of partnership property (sec. 754). Under a section 754 election, the transfer of a partnership interest generally results in an adjustment in the partnership's basis in its property for the benefit of the transferee partner only, to reflect the difference between that partner's basis for his interest and his proportionate share of the adjusted basis of partnership property (sec. 743(b)). Also under the election, a distribution of property to a partner in certain cases results in an adjustment in the basis of other partnership property (sec. 734(b)).

Terminations

A partnership terminates if either (1) All partners cease carrying on the business, financial operation or venture of the partnership, or (2) within a 12-month period 50 percent or more of the total partnership interests are sold or exchanged (sec. 708).

Reasons for Change

The requirement that each partner take into account separately his distributive share of a partnership's items of income, gain, loss, deduction and credit can result in the reporting of a large number of items to each partner. The schedule K–1, on which such items are reported, contains space for more than 40 items. Reporting so many separately stated items is burdensome for individual investors with relatively small, passive interests in large partnerships. In many respects such investments are indistinguishable from those made in corporate stock or mutual funds, which do not require reporting of numerous separate items.

In addition, the number of items reported under the current regime makes it difficult for the Internal Revenue Service to match items reported on the K–1 against the partner's income tax return. Matching is also difficult because items on the K–1 are often modified or limited at the partner level before appearing on the partner's tax return.

By significantly reducing the number of items that must be separately reported to partners by an electing large partnership, the provision eases the reporting burden of partners and facilitates matching by the IRS. Moreover, it is understood that the Internal Revenue Service is considering restricting the use of substitute reporting forms by large partnerships. Reduction of the number of items makes possible a short standardized form.

Explanation of Provisions

In general

The bill modifies the tax treatment of an electing large partnership (generally, any partnership that elects under the provision, if the number of partners in the preceding taxable year is 100 or more) and its partners. The provision provides that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; (10) creditable foreign taxes and foreign source items; and (11) any other items to the extent that the Secretary determines that separate treatment of such items is appropriate.[134] Separate treatment may be appropriate, for example, should changes in the law necessitate such treatment for any items.

Under the bill, the taxable income of an electing large partnership is computed in the same manner as that of an individual, except that the items described above are separately stated and certain modifications are made. These modifications include disallowing the deduction for personal exemptions, the net operating loss deduction and certain itemized deductions.[135] All limitations and other provisions affecting the computation of taxable income or any credit (except for the at risk, passive loss and itemized deduction limitations, and any other provision specified in regulations) are applied at the partnership (and not the partner) level.

All elections affecting the computation of taxable income or any credit generally are made by the partnership.

Capital gains

Under the bill, netting of capital gains and losses occurs at the partnership level. A partner in a large partnership takes into account separately his distributive share of the partnership's net cap-

[134] In determining the amounts required to be separately taken into account by a partner, those provisions of the large partnership rules governing computations of taxable income are applied separately with respect to that partner by taking into account that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit. This rule permits partnerships to make otherwise valid special allocations of partnership items to partners.

[135] An electing large partnership is allowed a deduction under section 212 for expenses incurred for the production of income, subject to 70-percent disallowance. No income from an electing large partnership is treated as fishing or farming income.

ital gain or net capital loss.[136] Such net capital gain or loss is treated as long-term capital gain or loss.

Any excess of net short-term capital gain over net long-term capital loss is consolidated with the partnership's other taxable income and is not separately reported.

A partner's distributive share of the partnership's net capital gain is allocated between passive loss limitation activities and other activities. The net capital gain is allocated to passive loss limitation activities to the extent of net capital gain from sales and exchanges of property used in connection with such activities, and any excess is allocated to other activities. A similar rule applies for purposes of allocating any net capital loss.

Any gains and losses of the partnership under section 1231 are netted at the partnership level. Net gain is treated as long-term capital gain and is subject to the rules described above. Net loss is treated as ordinary loss and consolidated with the partnership's other taxable income.

Deductions

The bill contains two special rules for deductions. First, miscellaneous itemized deductions are not separately reported to partners. Instead, 70 percent of the amount of such deductions is disallowed at the partnership level;[137] the remaining 30 percent is allowed at the partnership level in determining taxable income, and is not subject to the two-percent floor at the partner level.

Second, charitable contributions are not separately reported to partners under the bill. Instead, the charitable contribution deduction is allowed at the partnership level in determining taxable income, subject to the limitations that apply to corporate donors.

Credits in general

Under the bill, general credits are separately reported to partners as a single item. General credits are any credits other than the low-income housing credit, the rehabilitation credit and the credit for producing fuel from a nonconventional source. A partner's distributive share of general credits is taken into account as a current year general business credit. Thus, for example, the credit for clinical testing expenses is subject to the present law limitations on the general business credit. The refundable credit for gasoline used for exempt purposes and the refund or credit for undistributed capital gains of a regulated investment company are allowed to the partnership, and thus are not separately reported to partners.

In recognition of their special treatment under the passive loss rules, the low-income housing and rehabilitation credits are separately reported.[138] In addition, the credit for producing fuel from a nonconventional source is separately reported.

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[136] The term "net capital gain" has the same meaning as in section 1222(11). The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the gains from sales or exchanges of capital assets. Thus, the partnership cannot offset any portion of capital losses against ordinary income.

[137] The 70 percent figure is intended to approximate the amount of such deductions that would be denied at the partner level as a result of the two-percent floor.

[138] It is understood that the rehabilitation and low-income housing credits which are subject to the same passive loss rules (i.e., in the case of the low-income housing credit, where the partnership interest was acquired or the property was placed in service before 1990) could be reported together on the same line.

The bill imposes credit recapture at the partnership level and determines the amount of recapture by assuming that the credit fully reduced taxes. Such recapture is applied first to reduce the partnership's current year credit, if any; the partnership is liable for any excess over that amount. Under the bill, the transfer of an interest in an electing large partnership does not trigger recapture.

Foreign taxes

The bill retains present-law treatment of foreign taxes. The partnership reports to the partner creditable foreign taxes and the source of any income, gain, loss or deduction taken into account by the partnership. Elections, computations and limitations are made by the partner.

Tax-exempt interest

The bill retains present-law treatment of tax-exempt interest. Interest on a State or local bond is separately reported to each partner.

Unrelated business taxable income

The bill retains present-law treatment of unrelated business taxable income. Thus, a tax-exempt partner's distributive share of partnership items is taken into account separately to the extent necessary to comply with the rules governing such income.

Passive losses

Under the bill, a partner in an electing large partnership takes in an electing to account separately his distributive share of the partnership's taxable income or loss from passive loss limitation activities. The term "passive loss limitation activity" means any activity involving the conduct of a trade or business (including any activity treated as a trade or business under sec. 469(c) (5) or (6)) and any rental activity. A partner's share of an electing large partnership's taxable income or loss from passive loss limitation activities is treated as an item of income or loss from the conduct of a trade or business which is a single passive activity, as defined in the passive loss rules. Thus, an electing large partnership generally is not required to separately report items from multiple activities.

A partner in an electing large partnership also takes into account separately his distributive share of the partnership's taxable income or loss from activities other than passive loss limitation activities. Such distributive share is treated as an item of income or expense with respect to property held for investment. Thus, portfolio income (e.g., interest and dividends) is reported separately and is reduced by portfolio deductions and allocable investment interest expense.

In the case of a partner holding an interest in an electing large partnership which is not a limited partnership interest, such partner's distributive share of any items are taken into account separately to the extent necessary to comply with the passive loss rules. Thus, for example, income of an electing large partnership is not treated as passive income with respect to the general partnership interest of a partner who materially participates in the partnership's trade or business.

Under the bill, the requirement that the passive loss rule be separately applied to each publicly traded partnership (sec. 469(k) of the Code) continues to apply.

Alternative minimum tax

Under the bill, alternative minimum tax ("AMT") adjustments and preferences are combined at the partnership level. An electing large partnership would report to partners a net AMT adjustment separately computed for passive loss limitation activities and other activities. In determining a partner's alternative minimum taxable income, a partner's distributive share of any net AMT adjustment is taken into account instead of making separate AMT adjustments with respect to partnership items. The net AMT adjustment is determined by using the adjustments applicable to individuals (in the case of partners other than corporations), and by using the adjustments applicable to corporations (in the case of corporate partners). Except as provided in regulations, the net AMT adjustment is treated as a deferral preference for purposes of the section 53 minimum tax credit.

Discharge of indebtedness income

If an electing large partnership has income from the discharge of any indebtedness, such income is separately reported to each partner. In addition, the rules governing such income (sec. 108) are applied without regard to the large partnership rules. Partner-level elections under section 108 are made by each partner separately. Thus, for example, the large partnership provisions do not affect section 108(d)(6), which provides that certain section 108 rules apply at the partner level, or section 108(b)(5), which provides for an election to reduce the basis of depreciable property. The large partnership provisions also do not affect the election under 108(c) (added by the Omnibus Budget Reconciliation Act of 1993) to exclude discharge of indebtedness income with respect to qualified real property business indebtedness.

REMICs

For purposes of the tax on partnerships holding residual interests in REMICs, all interests in an electing large partnership are treated as held by disqualified organizations. Thus, an electing large partnership holding a residual interest in a REMIC is subject to a tax equal to the excess inclusions multiplied by the highest corporate rate. The amount subject to tax is excluded from partnership income.

Election of optional basis adjustments

Under the bill, an electing large partnership may still elect to adjust the basis of partnership assets with respect to transferee partners. The computation of an electing large partnership's taxable income is made without regard to the section 743(b) adjustment. As under present law, the section 743(b) adjustment is made only with respect to the transferee partner. In addition, an electing large partnership is permitted to adjust the basis of partnership property under section 734(b) if property is distributed to a partner, as under present law.

Terminations

The bill provides that an electing large partnership does not terminate for tax purposes solely because 50 percent of its interests are sold or exchanged within a 12-month period.

Partnerships and partners subject to large partnership rules

Definition of electing large partnership

An "electing large partnership" is any partnership that elects under the provision, if the number of partners in the preceding taxable year is 100 or more. The number of partners is determined by counting only persons directly holding partnership interests in the taxable year, including persons holding through nominees; persons holding indirectly (e.g., through another partnership) are not counted. Regulations may provide, however, that if the number of partners in any taxable year falls below 100, the partnership may not be treated as an electing large partnership. The election applies to the year for which made and all subsequent years and cannot be revoked without the Secretary's consent.

Special rules for certain service partnerships

An election under this provision is not effective for any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership's activities, or personal service corporations the owner-employees of which perform such services; (2) retired partners who had performed such services; or (3) spouses of partners who had performed such services. In addition, the term "partner" does not include any individual performing substantial services in connection with the partnership's activities and holding a partnership interest, or an individual who formerly performed such services and who held a partnership interest at the time the individual performed such services.

Exclusion for commodity partnerships

An election under this provision is not effective for any partnership the principal activity of which is the buying and selling of commodities (not described in sec. 1221(1)), or options, futures or forwards with respect to commodities.

Special rules for partnerships holding oil and gas properties

Simplified reporting treatment of electing large partnerships with oil and gas activities

The bill provides special rules for electing large partnerships with oil and gas activities that operate under the simplified reporting regime. These partnerships are collectively referred to herein as "oil and gas large partnerships." Generally, the bill provides that an oil and gas large partnership reports information to its partners under the general simplified large partnership reporting regime described above. To prevent the extension of percentage depletion deductions to persons excluded therefrom under present law, however, certain partners are treated as disqualified persons under the bill.

The treatment of a disqualified person's distributive share of any item of income, gain, loss, deduction, or credit attributable to any partnership oil or gas property is determined under the bill without regard to the special rules applicable to large partnerships. Thus, an oil and gas large partnership reports information related to oil and gas activities to a partner who is a disqualified person in the same manner and to the same extent that it reports such information to that partner under present law. The simplified reporting rules of the bill, however, apply with respect to reporting such a partner's share of items not related to oil and gas activities.

The bill defines two categories of taxpayers as disqualified persons. The first category encompasses taxpayers who do not qualify for the deduction for percentage depletion under section 613A (i.e., integrated producers of oil and gas). The second category includes any person whose average daily production of oil and gas (for purposes of determining the depletable oil and natural gas quantity under section 613A(c)(2)) is at least 500 barrels for its taxable year in which (or with which) the partnership's taxable year ends. In making this computation, all production of domestic crude oil and natural gas attributable to the partner is taken into account, including such partner's proportionate share of any production of the large partnership.

A taxpayer that falls within a category of disqualified person has the responsibility of notifying any large partnership in which it holds a direct or indirect interest (e.g., through a pass-through entity) of its status as such. Thus, for example, if an integrated producer owns an interest in a partnership which in turn owns an interest in an oil and gas large partnership, it is responsible for providing the management of the electing large partnership information regarding its status as a disqualified person and details regarding its indirect interest in the electing large partnership.

Under the bill, an oil and gas large partnership computes its deduction for oil and gas depletion under the general statutory rules (subject to certain exceptions described below) under the assumptions that the partnership is the taxpayer and that it qualifies for the percentage depletion deduction. The amount of the depletion deduction, as well as other oil and gas related items, generally are reported to each partner (other than to partners who are disqualified persons) as components of that partner's distributive share of taxable income or loss from passive loss limitation activities. The bill provides that in computing the partnership's oil and gas percentage depletion deduction, the 1,000-barrel-per-day limitation does not apply. In addition, an oil and gas large partnership is allowed to compute percentage depletion under the bill without applying the 65-percent-of-taxable-income limitation under section 613A(d)(1).

As under present law, an election to deduct IDCs under section 263(c) is made at the partnership level. Since the bill treats those taxpayers required by the Code (sec. 291) to capitalize 30 percent of IDCs as disqualified persons, an oil and gas large partnership may pass through a full deduction of IDCs to its partners who are not disqualified persons. In contrast to present law, an oil and gas large partnership also has the responsibility with respect to its partners who are not disqualified persons for making an election under section 59(e) to capitalize and amortize certain specified IDCs. Partners who are disqualified persons are permitted to make their own separate section 59(e) elections under the bill.

Consistent with the general reporting regime for electing large partnerships, the bill provides that a single AMT adjustment (under either corporate or non-corporate principles, as the case may be) is made and reported to the partners (other than disqualified persons) of an oil and gas large partnership as a separate item. This separately-reported item is affected by the limitation on the repeal of the tax preference for excess IDCs. For purposes of computing this limitation, the bill treats an oil and gas large partnership as the taxpayer. Thus, the limitation on repeal of the IDC preference is applied at the partnership level and is based on the cumulative reduction in the partnership's alternative minimum taxable income resulting from repeal of that preference.

The bill provides that in making partnership-level computations, any item of income, gain, loss, deduction, or credit attributable to a partner who is a disqualified person is disregarded. For example, in computing the partnership's net income from oil and gas for purposes of determining the IDC preference (if any) to be reported to partners who are not disqualified persons as part of the AMT adjustment, disqualified persons' distributive shares of the partnership's net income from oil and gas are not to be taken into account.

Regulatory authority

The Secretary of the Treasury is granted authority to prescribe such regulations as may be appropriate to carry out the purposes of the provisions.

Effective Date

The provisions generally applies to partnership taxable years beginning after December 31, 1997.

b. Simplified audit procedures for electing large partnerships (sec. 1022 of the bill and secs. 6240, 6241, 6242, 6245, 6246, 6247, 6249, 6251, 6255, and 6256 of the Code)

Present Law

In general

Prior to 1982, regardless of the size of a partnership, adjustments to a partnership's items of income, gain, loss, deduction, or credit had to be made in separate proceedings with respect to each partner individually. Because a large partnership sometimes had many partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the partnership had to be made in numerous actions in several jurisdictions, sometimes with conflicting outcomes.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

Administrative proceedings

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. But the IRS must still assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

Any partner of a partnership can request an administrative adjustment or a refund for his own separate tax liability. Any partner also has the right to participate in partnership-level administrative proceedings. A settlement agreement with respect to partnership items binds all parties to the settlement.

Tax Matters Partner

The TEFRA rules establish the "Tax Matters Partner" as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice requirements

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Adjudication of disputes concerning partnership items

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Statute of limitations

The IRS generally cannot adjust a partnership item for a partnership taxable year if more than 3 years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return.

Reasons for Change

Present audit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located and some of whom are no longer partners. In addition, audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually.

Explanation of Provision

The bill creates a new audit system for electing large partnerships. The provision defines "electing large partnership" the same way for audit and reporting purposes (generally, any partnership that elects under the reporting provisions, if the number of partners in the preceding taxable year is 100 or more).

As under present law, electing large partnerships and their partners are subject to unified audit rules. Thus, the tax treatment of "partnership items" are determined at the partnership, rather than the partner, level. The term "partnership items" is defined as under present law.

Unlike present law, however, partnership adjustments generally will flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits will be adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior-year returns of any partners (except in the case of changes to any partner's distributive shares).

In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the adjustments to the income and loss items of the partnership and multiplying that amount by the highest tax rate (whether individual or corporate). A partner may not file a claim for credit or refund of his allocable share of the payment. A partnership may make this election only if it meets requirements set forth in Treasury regulations designed to ensure payment (for example, in the case of a foreign partnership).

Regardless of whether a partnership adjustment flows through to the partners, an adjustment must be offset if it requires another adjustment in a year after the adjusted year and before the year the offsetted adjustment takes effect. For example, if a partnership expensed a $1,000 item in year 1, and it was determined in year 4 that the item should have been capitalized and amortized ratably over 10 years, the adjustment in year 4 would be $700, apart from any interest or penalty. (The $900 adjustment for the improper deduction would be offset by $200 of adjustments for amortization deductions.) The year 4 partners would be required to include an additional $700 in income for that year. The partnership may ratably amortize the remaining $700 of expenses in years 4–10.

In addition, the partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment. Interest is computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Thus, in the above example, the partnership would be liable for 4 years' worth of interest (on a declining principal amount).

Penalties (such as the accuracy and fraud penalties) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy penalty criteria and waiver criteria (such as reasonable cause, substantial authority, etc.) are determined as if the partnership were a taxable individual. Accuracy and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual.

Any payment (for Federal income taxes, interest, or penalties) that an electing large partnership is required to make is non-deductible.

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to prevent abuse and to enforce efficiently the audit rules in circumstances that present special enforcement considerations (such as partnership bankruptcy).

Administrative proceedings

Under the electing large partnership audit rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS may treat a partnership item that was reported inconsistently by a partner as a mathematical or clerical error and immediately assess any additional tax against that partner.

As under present law, the IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike under present law, however, partners will have no right individually to participate in settlement conferences or to request a refund.

Partnership representative

The bill requires each electing large partnership to designate a partner or other person to act on its behalf. If an electing large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. After the IRS's designation, an electing large partnership could still designate a replacement for the IRS-designated partner.

Notice requirements

Unlike under present law, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS could give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence.

Adjudication of disputes concerning partnership items

As under present law, an administrative adjustment could be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items.

If a petition for readjustment of partnership items is filed by the partnership, the court with which the petition is filed will have jurisdiction to determine the tax treatment of all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates, and the proper allocation of such items among the partners. Thus, the court's jurisdiction is not limited to the items adjusted in the notice.

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally could not adjust a partnership item of an electing large partnership more than 3 years after the later of the filing of the partnership return or the last day for the filing of the partnership return. Special rules apply to false or fraudulent returns, a substantial omission of income, or the failure to file a return. The IRS would assess and collect any deficiency of a partner that arises from any adjustment to a partnership item subject to the limitations period on assessments and collection applicable to the year the adjustment takes effect (secs. 6248, 6501 and 6502).

Regulatory authority

The Secretary of the Treasury is granted authority to prescribe regulations as may be necessary to carry out the simplified audit procedure provisions, including regulations to prevent abuse of the provisions through manipulation. The regulations may include rules that address transfers of partnership interests, in anticipation of a partnership adjustment, to persons who are tax-favored (e.g., corporations with net operating losses, tax-exempt organizations, and foreign partners) or persons who are expected to be unable to pay tax (e.g., shell corporations). For example, if prior to the time a partnership adjustment takes effect, a taxable partner transfers a partnership interest to a nonresident alien to avoid the tax effect of the partnership adjustment, the rules may provide, among other things, that income related to the partnership adjustment is treated as effectively connected taxable income, that the partnership adjustment is treated as taking effect before the partnership interest was transferred, or that the former partner is treated as a current partner to whom the partnership adjustment is allocated.

Effective Date

The provision applies to partnership taxable years beginning after December 31, 1997.

c. Due date for furnishing information to partners of electing large partnerships (sec. 1023 of the bill and sec. 6031(b) of the Code)

Present Law

A partnership required to file an income tax return with the Internal Revenue Service must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a partnership must file its income tax return on or before the fifteenth day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships). This is the same deadline by which most individual partners must file their tax returns.

Reasons for Change

Information returns that are received on or shortly before April 15 (or later) are difficult for individuals to use in preparing their tax returns (or in computing their payments) that are due on that date.

Explanation of Provision

The bill provides that an electing large partnership must furnish information returns to partners by the first March 15 following the close of the partnership's taxable year. Electing large partnerships are those partnerships subject to the simplified reporting and audit rules (generally, any partnership that elects under the reporting provision, if the number of partners in the preceding taxable year is 100 or more).

The provision also provides that, if the partnership is required to provide copies of the information returns to the Internal Revenue Service on magnetic media, each schedule (such as each Schedule K-1) with respect to each partner is treated as a separate information return with respect to the corrective periods and penalties that are generally applicable to all information returns.

Effective Date

The provision is effective for partnership taxable years beginning after December 31, 1997.

d. Partnership returns required on magnetic media (sec. 1024 of the bill and sec. 6011 of the Code)

Present Law

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Reasons for Change

Most entities that file large numbers of documents with the Internal Revenue Service must do so on magnetic media. Conforming the reporting provisions for partnerships to the generally applicable information reporting rules will facilitate integration of partnership information into already existing data systems.

Explanation of Provision

The bill provides generally that any partnership is required to provide the tax return of the partnership (Form 1065), as well as copies of the schedule sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media. An exception is provided for partnerships with 100 or fewer partners.

Effective Date

The provision is effective for partnership taxable years beginning after December 31, 1997.

e. Treatment of partnership items of individual retirement arrangements (sec. 1025 of the bill and sec. 6012 of the Code)

Present Law

Return filing requirements

An individual retirement account ("IRA") is a trust which generally is exempt from taxation except for the taxes imposed on income from an unrelated trade or business. A fiduciary of a trust that is exempt from taxation (but subject to the taxes imposed on income from an unrelated trade or business) generally is required to file a return on behalf of the trust for a taxable year if the trust has gross income of $1,000 or more included in computing unrelated business taxable income for that year (Treas. Reg. sec. 1.6012-3(a)(5)).

Unrelated business taxable income is the gross income (including gross income from a partnership) derived by an exempt organization from an unrelated trade or business, less certain deductions which are directly connected with the carrying on of such trade or business (sec. 512(a)(1). In calculating unrelated business taxable income, exempt organizations (including IRAs) generally also are permitted a specific deduction of $1,000 (sec. 512(b)(12)).

Unified audits of partnerships

All but certain small partnerships are subject to unified audit rules established by the Tax Equity and Fiscal Responsibility Act of 1982. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, including such items as gross income and deductions of the partnership.

Reasons for Change

Under present law, tax returns often must be filed for IRAs that have no taxable income and, consequently, no tax liability. The filing of these returns by taxpayers, and the processing of these returns by the IRS, impose significant costs. Imposing this burden is unnecessary to the extent that the income of the IRA has been derived from an interest in a partnership that is subject to partnership-level audit rules. In these circumstances, the appropriateness of any deductions may be determined at the partnership level, and an additional filing is unnecessary to facilitate this determination.

Explanation of Provision

The bill modifies the filing threshold for an IRA with an interest in a partnership that is subject to the partnership-level audit rules. A fiduciary of such an IRA could treat the trust's share of partnership taxable income as gross income, for purposes of determining whether the trust meets the $1,000 gross income filing threshold. A fiduciary of an IRA that receives taxable income from a partnership that is subject to partnership-level audit rules of less than $1,000 (before the $1,000 specific deduction) is not required to file an income tax return if the IRA does not have any other income from an unrelated trade or business.

Effective Date

The provision applies to taxable years beginning after December 31, 1997.

2. Other partnership audit rules

a. Treatment of partnership items in deficiency proceedings (sec. 1031 of the bill and sec. 6234 of the Code)

Present Law

Partnership proceedings under rules enacted in TEFRA[139] must be kept separate from deficiency proceedings involving the partners in their individual capacities. Prior to the Tax Court's opinion in *Munro v. Commissioner,* 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding, and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

Faced with this situation in *Munro*, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that

[139] Tax Equity and Fiscal Responsibility Act of 1982.

the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Reasons for Change

The opinion in *Munro* creates problems for both taxpayers and the IRS. For example, a taxpayer would be harmed in the case where he has invested in a TEFRA partnership and is also subject to the deficiency procedures with respect to nonpartnership item adjustments, since computing the tax liability without regard to partnership items will have the same effect as if the partnership items were disallowed. If the partnership items were losses, the effect will be a greatly increased deficiency for the nonpartnership items. If, when the partnership proceedings are completed, the taxpayer is ultimately allowed any part of the losses, the taxpayer will receive part of the increased deficiency back in the form of an overpayment. However, in the interim, the taxpayer will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding. In essence, a taxpayer in such a case would be deprived of a prepayment forum with respect to the partnership item adjustments. The IRS would be harmed if a taxpayer's income is primarily from a TEFRA partnership, since the IRS may be unable to adjust nonpartnership items such as medical expense deductions, home mortgage interest deductions on charitable contribution deductions because there would be no deficiency since, under *Munro,* the income must be ignored.

Explanation of Provision

The bill overrules *Munro* and allow the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This eliminates the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and will restore to taxpayers a prepayment forum with respect to the TEFRA items. In addition, the provision provides a special rule to address the factual situation presented in *Munro.*

Specifically, the bill provides a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return is a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS is authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment. However, the IRS could only issue such a notice if a deficiency would have arisen in the absence of the net loss from TEFRA partnerships.

The Tax Court is granted jurisdiction to determine the correctness of such an adjustment as well as to make a declaration with respect to any other item for the taxable year to which the notice of adjustment relates, except for partnership items and affected items which require partner-level determinations. No tax is due upon such a determination, but a decision of the Tax Court is treated as a final decision, permitting an appeal of the decision by either the taxpayer or the IRS. An adjustment determined to be correct would thus have the effect of increasing the taxable income that is deemed to have been reported on the taxpayer's return. If the taxpayer's partnership items were then adjusted in a subsequent proceeding, the IRS has preserved its ability to collect tax on any increased deficiency attributable to the nonpartnership items.

Alternatively, if the taxpayer chooses not to contest the notice of adjustment within the 90-day period, the bill provides that when the taxpayer's partnership items are finally determined, the taxpayer has the right to file a refund claim for tax attributable to the items adjusted by the earlier notice of adjustment for the taxable year. Although a refund claim is not generally permitted with respect to a deficiency arising from a TEFRA proceeding, such a rule is appropriate with respect to a defaulted notice of adjustment because taxpayers may not challenge such a notice when issued since it does not require the payment of additional tax.

In addition, the bill incorporates a number of provisions intended to clarify the coordination between TEFRA audit proceedings and individual deficiency proceedings. Under these provisions, any adjustment with respect to a non-partnership item that caused an increase in tax liability with respect to a partnership item would be treated as a computational adjustment and assessed after the conclusion of the TEFRA proceeding. Accordingly, deficiency procedures do not apply with respect to this increase in tax liability, and the statute of limitations applicable to TEFRA proceedings are controlling.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment.

b. Partnership return to be determinative of audit procedures to be followed (sec. 1032 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Change

The IRS often finds it difficult to determine whether to follow the TEFRA partnership procedures or the regular deficiency procedures. If the IRS determines that there were fewer than 10 partners in the partnership but was unaware that one of the partners was a nonresident alien or that there was a special allocation made during the year, the IRS might inadvertently apply the wrong procedures and possibly jeopardize any assessment. Permitting the IRS to rely on a partnership's return would simplify the IRS' task.

Explanation of Provision

The bill permits the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the provision permits the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment.

c. Provisions relating to statute of limitations

i. Suspend statute when an untimely petition is filed (sec. 1033(a) of the bill and sec. 6229 of the Code)

Present Law

In a deficiency case, section 6503(a) provides that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection is suspended until the decision of the Tax Court becomes final, and for 60 days thereafter. The counterpart to this provision with respect to TEFRA cases is contained in section 6229(d). That section provides that the period of limitations is suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely.

Reasons for Change

Under present law, if an untimely petition is filed in a TEFRA case, the statute of limitations can expire while the case is still pending before the court. To prevent this from occurring, the IRS must make assessments against all of the investors during the pendency of the action and if the action is in the Tax Court, presumably abate such assessments if the court ultimately determines that the petition was timely. These steps are burdensome to the IRS and to taxpayers.

Explanation of Provision

The bill conforms the suspension rule for the filing of petitions in TEFRA cases with the rule under section 6503(a) pertaining to deficiency cases. Under the provision, the statute of limitations in

TEFRA cases is suspended by the filing of any petition under section 6226, regardless of whether the petition is timely or valid, and the suspension will remain in effect until the decision of the court becomes final, and for one year thereafter. Hence, if the statute of limitations is open at the time that an untimely petition is filed, the limitations period would no longer continue to run and possibly expire while the action is pending before the court.

Effective Date

The provision is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

ii. Suspend statute of limitations during bankruptcy proceedings (sec. 1033(b) of the bill and sec. 6229 of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502.

Under present law, because the suspension provision in section 6503(h) applies only to the limitations periods provided in section 6501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result, the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay provisions of the Bankruptcy Code.

Reasons for Change

The ambiguity in present law makes it difficult for the IRS to adjust partnership items that convert to nonpartnership items by reason of a partner going into bankruptcy. In addition, any uncertainty may result in increased requests for the bankruptcy court to lift the automatic stay to permit the IRS to make an assessment with respect to the converted items.

Explanation of Provision

The bill clarifies that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period is for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment, and for 60 days thereafter. The provision does not purport to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

iii. Extend statute of limitations for bankrupt TMPs (sec. 1033(c) of the bill and sec. 6229 of the Code)

Present Law

Section 6229(b)(1)(B) provides that the statute of limitations is extended with respect to all partners in the partnership by an agreement entered into between the tax matters partner (TMP) and the IRS. However, Temp. Treas. Reg. secs. 301.6231(a)(7)-1T(1)(4) and 301.6231(c)-7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items convert to nonpartnership items, and if the debtor was the tax matters partner, such status terminates. These rules are necessary because of the automatic stay provision contained in 11 U.S.C. sec. 362(a)(8). As a result, if a consent to extend the statute of limitations is signed by a person who would be the TMP but for the fact that at the time that the agreement is executed the person was a debtor in a bankruptcy proceeding, the consent would not be binding on the other partners because the person signing the agreement was no longer the TMP at the time that the agreement was executed.

Reasons for Change

The IRS is not automatically notified of bankruptcy filings and cannot easily determine whether a taxpayer is in bankruptcy, especially if the audit of the partnership is being conducted by one district and the taxpayer resides in another district, as is frequently the situation in TEFRA cases. If the IRS does not discover that a person signing a consent is in bankruptcy, the IRS may mistakenly rely on that consent. As a result, the IRS may be precluded from assessing any tax attributable to partnership item adjustments with respect to any of the partners in the partnership.

Explanation of Provision

The bill provides that unless the IRS is notified of a bankruptcy proceeding in accordance with regulations, the IRS can rely on a statute extension signed by a person who is the tax matters partner but for the fact that said person was in bankruptcy at the time that the person signed the agreement. Statute extensions granted by a bankrupt TMP in these cases are binding on all of the partners in the partnership. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective for extension agreements entered into after the date of enactment.

d. Expansion of small partnership exception (sec. 1034 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Change

The mere existence of a C corporation as a partner or of a special allocation does not warrant subjecting the partnership and its partners of an otherwise small partnership to the TEFRA procedures.

Explanation of Provision

The bill permits a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the provision retains the prohibition of present law against having a flow-through entity (other than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment.

e. Exclusion of partial settlements from 1-year limitation on assessment (sec. 1035 of the bill and sec. 6229(f) of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

Reasons for Change

When a partial settlement agreement is entered into, the assessment period for the items covered by the agreement may be different than the assessment period for the remaining items. This fractured statute of limitations poses a significant tracking problem for the IRS and necessitates multiple computations of tax with respect to each partner's investment in the partnership for the taxable year.

Explanation of Provision

The bill provides that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items is determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year is controlling with respect to all disputed partnership items for the partnership taxable year. The provision does not purport to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective for settlements entered into after the date of enactment.

f. Extension of time for filing a request for administrative adjustment (sec. 1036 of the bill and sec. 6227 of the Code)

Present Law

If an agreement extending the statute is entered into with respect to a non-TEFRA statute of limitations, that agreement also extends the statute of limitations for filing refund claims (sec. 6511(c)). There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Reasons for Change

The absence of an extension for filing refund claims in TEFRA proceedings hinders taxpayers that may want to agree to extend the TEFRA statute of limitations but want to preserve their option to file a refund claim later.

Explanation of Provision

The bill provides that if a TEFRA statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims attributable to partnership items or affected items until 6 months after the expiration of the limitations period for assessments.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

g. Availability of innocent spouse relief in context of partnership proceedings (sec. 1037 of the bill and sec. 6230 of the Code)

Present Law

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (sec. 6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Reasons for Change

Providing a forum in which to raise the innocent spouse defense with respect to liabilities attributable to adjustments to partnership items (including penalties, additions to tax and additional amounts) would make the innocent spouse rules more uniform.

Explanation of Provision

The bill provides both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

With respect to a prepayment forum, the provision provides that within 60 days of the date that a notice of computational adjustment relating to partnership items is mailed to the spouse of a partner, the spouse could request that the assessment be abated. Upon receipt of such a request, the assessment is abated and any reassessment will be subject to the deficiency procedures. If an abatement is requested, the statute of limitations does not expire before the date which is 60 days after the date of the abatement. If the spouse files a petition with the Tax Court, the Tax Court only has jurisdiction to determine whether the requirements of section 6013(e) have been satisfied. In making this determination, the treatment of the partnership items that gave rise to the liability in question is conclusive.

Alternatively, the bill provides that the spouse of a partner could file a claim for refund to raise the innocent spouse defense. The claim has to be filed within 6 months from the date that the notice of computational adjustment is mailed to the spouse. If the claim is not allowed, the spouse could file a refund action. For purposes of any claim or suit under this provision, the treatment of the partnership items that gave rise to the liability in question is conclusive.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

h. Determination of penalties at partnership level (sec. 1038 of the bill and sec. 6221 of the Code)

Present Law

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Reasons for Change

Many penalties are based upon the conduct of the taxpayer. With respect to partnerships, the relevant conduct often occurs at the partnership level. In addition, applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the Tax Court's inventory.

Explanation of Provision

The bill provides that the partnership-level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the provision allows partners to raise any partner-level defenses in a refund forum.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment.

i. Provisions relating to Tax Court jurisdiction (sec. 1039 of the bill and secs. 6225 and 6226 of the Code)

Present Law

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding, "may be enjoined in the proper court." Present law may be unclear as to whether this includes the Tax Court.

For a partner other than the Tax Matters Partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to them.

Reasons for Change

Clarifying the Tax Court's jurisdiction simplifies the resolution of tax cases.

Explanation of Provision

The bill clarifies that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The provision also permits a partner to participate in an action or file a petition for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person. Additionally, the provision clarifies that the Tax Court has overpayment jurisdiction with respect to affected items.

Effective Date

The provision is effective for partnership taxable years ending after the date of enactment.

j. Treatment of premature petitions filed by notice partners or 5-percent groups (sec. 1040 of the bill and sec. 6226 of the Code)

Present Law

The Tax Matters Partner is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the Tax Matters Partner does not file a petition within the 90-day period, certain other partners are permitted to file a petition within the 60-day period after the close of the 90-day period. There are ordering rules for determining which action goes forward and for dismissing other actions.

Reasons for Change

A petition that is filed within the 90-day period by a person who is not the Tax Matters Partner is dismissed. Thus, if the Tax Matters Partner does not file a petition within the 90-day period and no timely and valid petition is filed during the succeeding 60-day period, judicial review of the adjustments set forth in the notice of FPAA is foreclosed and the adjustments are deemed to be correct.

Explanation of Provision

The bill treats premature petitions filed by certain partners within the 90-day period as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that is not available under present law.

Effective Date

The provision is effective with respect to petitions filed after the date of enactment.

k. Bonds in case of appeals from certain proceedings (sec. 1041 of the bill and sec. 7485 of the Code)

Present Law

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

Reasons for Change

The Tax Court cannot easily determine the aggregate changes in tax liability of all of the partners in a partnership who will be affected by the Court's decision in the proceeding. Clarifying the calculation of the bond amount would simplify the Tax Court's task.

Explanation of Provision

The bill clarifies that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership). For purposes of this provision, the amount of the bond could be estimated by applying the highest individual rate to the total adjustments determined by the Tax Court and doubling that amount to take into account interest and penalties.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

l. Suspension of interest where delay in computational adjustment resulting from certain settlements (sec. 1042 of the bill and sec. 6601 of the Code)

Present Law

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections, and the IRS does not issue a notice and demand for payment of such deficiency within 30 days. Interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings, however, is not suspended.

Reasons for Change

Processing settlement agreements and assessing the tax due takes a substantial amount of time in TEFRA cases. A taxpayer is not afforded any relief from interest during this period.

Explanation of Provision

The bill suspends interest where there is a delay in making a computational adjustment relating to a TEFRA settlement.

Effective Date

The provision is effective with respect to adjustments relating to taxable years beginning after the date of enactment.

m. Special rules for administrative adjustment requests with respect to bad debts or worthless securities (sec. 1043 of the bill and sec. 6227 of the Code)

Present Law

The non-TEFRA statute of limitations for filing a claim for credit or refund generally is the later of (1) three years from the date the return in question was filed or (2) two years from the date the claimed tax was paid, whichever is later (sec. 6511(b)). However, an extended period of time, seven years from the date the return was due, is provided for filing a claim for refund of an overpayment resulting from a deduction for a worthless security or bad debt (sec. 6511(d)).

Under the TEFRA partnership rules, a request for administrative adjustment ("RAA") must be filed within three years after the later of (1) the date the partnership return was filed or (2) the due date of the partnership return (determined without regard to extensions) (sec. 6227(a)(1)). In addition, the request must be filed before a final partnership administrative adjustment ("FPAA") is mailed for the taxable year (sec. 6227(a)(2)). There is no special provision for extending the time for filing an RAA that relates to a deduction for a worthless security or an entirely worthless bad debt.

Reasons for Change

Whether and when a stock or debt becomes worthless is a question of fact that may not be determinable until after the year in which it appears the loss has occurred. An extended statute of limitations allows partners in a TEFRA partnership the same opportunity to file a delayed claim for refund in these difficult factual situations as other taxpayers are permitted.

Further, on past occasions, the IRS issued FPAAs that did not adjust the partnership's tax return. This action created wasteful paperwork, and may have, in some cases truncated the appeals rights of individual partners. A special rule is necessary to permit partners who may have been adversely impacted by this past practice of the IRS to avail themselves of the extended period irrespective of whether an FPAA has been issued.

Explanation of Provision

The bill extends the time for the filing of an RAA relating to the deduction by a partnership for a worthless security or bad debt. In these circumstances, in lieu of the three-year period provided in sec. 6227(a)(1), the period for filing an RAA is seven years from the date the partnership return was due with respect to which the request is made (determined without regard to extensions). The RAA is still required to be filed before the FPAA is mailed for the taxable year.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

3. Closing of partnership taxable year with respect to deceased partner (sec. 1046 of the bill and sec. 706(c)(2)(A) of the Code)

Present Law

The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Such year, however, generally does not close upon the death of a partner. Thus, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return. See *Estate of Hesse* v. *Commissioner,* 74 T.C. 1307, 1311 (1980).

Reasons for Change

The rule leaving open the partnership taxable year with respect to a deceased partner was adopted in 1954 to prevent the bunching of income that could occur with respect to a partnership reporting on a fiscal year other than the calendar year. Without this rule, as many as 23 months of income might have been reported on the partner's final return. Legislative changes occurring since 1954 have required most partnerships to adopt a calendar year, reducing the possibility of bunching. Consequently, income and deductions are better matched if the partnership taxable year closes upon a partner's death and partnership items are reported on the decedent's last return.

Present law closes the partnership taxable year with respect to a deceased partner only if the partner's entire interest is sold or exchanged pursuant to an agreement existing at the time of death. By closing the taxable year automatically upon death, the provision reduces the need for such agreements.

Explanation of Provision

The provision provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise. The provision does not change present law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

Effective Date

The provision applies to partnership taxable years beginning after December 31, 1997.

D. Modifications of Rules for Real Estate Investment Trusts (secs. 1051–1063 of the bill and secs. 856 and 857 of the Code)

Present Law

Overview

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT generally is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies as foreclosure property.

Election to be treated as a REIT

In order to qualify as a REIT, and thereby receive conduit treatment, an entity must elect REIT status. A newly-electing entity generally cannot have earnings and profits accumulated from any year in which the entity was in existence and not treated as a REIT (sec. 857(a)(3)). To satisfy this requirement, the entity must distribute, during its first REIT taxable year, any earnings and profits that were accumulated in non-REIT years. For this purpose, distributions by the entity generally are treated as being made from the most recently accumulated earnings and profits.

Taxation of REITs

Overview

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts (sec. 857). REITTI is the taxable income of the REIT with certain adjustments (sec. 857(b)(2)). The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes.

Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the capital gains tax regime generally applicable to corporations (sec. 857(b)(3)). However, a REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders (sec. 857(b)(3)(C)). A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of their holding period of the stock (sec. 857(b)(3)(C)).

A regulated investment company ("RIC"), but not a REIT, may elect to retain and pay income tax on net long-term capital gains it received during the tax year. If a RIC makes this election, the RIC shareholders must include in their income as long-term capital gains their proportionate share of these undistributed long-term capital gains as designated by the RIC. The shareholder is deemed to have paid the shareholder's share of the tax, which can be credited or refunded to the shareholder. Also, the basis of the shareholder's shares is increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the RIC) included in the shareholder's long-term capital gains.

Income from foreclosure property

In addition to tax on its REITTI, a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property (sec. 857(b)(4)). Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or business and gross income from foreclosure property (other than income that otherwise would qualify under the 75-percent income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property), such property was not held by the REIT for sale to customers (sec. 856(e)). A property generally may be treated as foreclosure property for a period of two years after the date the property is acquired by the REIT. The IRS may grant extensions of the period for treating the property as foreclosure property if the REIT establishes that an extension of the grace period is necessary for the orderly liquidation of the REIT's interest in the property. The grace period cannot be extended beyond six years from the date the property is acquired by the REIT.

Property will cease to be treated as foreclosure property if, after 90 days after the date of acquisition, the REIT operates the foreclosure property in a trade or business other than through an independent contractor from whom the REIT does not derive or receive any income (sec. 856(e)(4)(C)).

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. Accordingly, in addition to the tax on its REITTI and on its net income from foreclosure property, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions" (sec. 857(b)(6)). A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. A safe harbor is provided for certain sales that otherwise might be considered prohibited transactions (sec. 857(b)(6)(C)). The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year.

Requirements for REIT status

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (sec. 856(a)). The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares.

Income requirements

Overview

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent test"), including rents from real property.

In addition, less than 30 percent of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than one year, real property held less than four years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of sec. 1033), and property that is sold or disposed of in a prohibited transaction (sec. 856(c)(4)).

Definition of rents

For purposes of the income requirements, rents from real property generally include rents from interests in real property, charges for services customarily rendered or furnished in connection with the rental of real property, whether or not such charges are separately stated, and rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease (sec. 856(d)(1)).

Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the collection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. sec. 1.856–4(b)).

In addition, amounts are not treated as qualifying rent if received from certain parties in which the REIT has an ownership interest of 10 percent or more (sec. 856(d)(2)(B)). For purposes of determining the REIT's ownership interest in a tenant, the attribution rules of section 318 apply, except that 10 percent is substituted for 50 percent where it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3) (sec. 856(d)(5)).

Finally, where a REIT furnishes or renders services to the tenants of rented property, amounts received or accrued with respect to such property generally are not treated as qualifying rents unless the services are furnished through an independent contractor (sec. 856(d)(2)(C)). A REIT may furnish or render a service directly, however, if the service would not generate unrelated business taxable income under section 512(b)(3) if provided by an organization described in section 511(a)(2). In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT, and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT (sec. 856(d)(3)).

Hedging instruments

Interest rate swaps or cap agreements that protect a REIT from interest rate fluctuations on variable rate debt incurred to acquire or carry real property are treated as securities under the 30-percent test and payments under these agreements are treated as qualifying under the 95-percent test (sec. 856(c)(6)(G)).

Treatment of shared appreciation mortgages

For purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, any income derived from a "shared appreciation provision" is treated as gain recognized on the sale of the "secured property." For these purposes, a shared appreciation provision is any provision that is in connection with an obligation that is held by the REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as property described in section 1221(1) if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT). For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and government securities (sec. 856(c)(5)(A)). Moreover, not more than 25 percent of the value of the entity's assets can be invested in securities of any one issuer (other than government securities and other securities described in the preceding sentence). Further, these securities may not comprise more than five percent of the entity's assets or more than 10 percent of the outstanding voting securities of such issuer (sec. 856(c)(5)(B)). The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs (sec. 856(c)(6)(B)).

REIT subsidiaries

Under present law, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100 percent of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiary's stock, or ceased to be a REIT as the case may be.

Distribution requirements

To satisfy the distribution requirement, a REIT must distribute as dividends to its shareholders during the taxable year an amount equal to or exceeding (i) the sum of 95 percent of its REITTI other than net capital gain income and 95 percent of the excess of its net income from foreclosure property over the tax imposed on that income minus (ii) certain excess noncash income (described below).

Excess noncash items include (a) the excess of the amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting, (2) in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to a loan to which section 1274 applies, over the amount of money and fair market value of other property received with respect to the loan, and (3) income arising from the disposition of a real estate asset in certain transactions that failed to qualify as like-kind exchanges under section 1031.

Reasons for Change

The REIT serves as a means whereby numerous small investors can have a practical opportunity to invest in a diversified portfolio of real estate assets and have the benefit of professional management. The committee believes that the asset requirements of present law ensure that a REIT acts as a pass-through entity for taxpayers wishing to invest in real estate. Therefore, the committee finds the 30-percent gross income test unnecessary and administratively burdensome. The committee further finds that financial markets have changed over the past decade such that interest risk can be managed by many strategies other than swaps and caps. Recognizing these developments in the financial markets, the committee believes it necessary to modify the classification of income from certain hedging instruments to provide flexibility to REITs in managing risk for their shareholders. The committee also believes that, as a pass- through entity, REITs should be permitted to retain the proceeds of realized capital gains in a manner comparable to that accorded to RICs.

Explanation of Provisions

Overview

The bill modifies many of the provisions relating to the requirements for qualification as, and the taxation of, a REIT. In particular, the modifications relate to the general requirements for qualification as a REIT, the taxation of a REIT, the income requirements for qualification as a REIT, and certain other provisions.

Clarification of limitation on maximum number of shareholders (sec. 1051 of the bill and secs. 856 (k), 857(a), and 857(f) of the Code)

The bill replaces the rule that disqualifies a REIT for any year in which the REIT failed to comply with Treasury regulations to ascertain its ownership, with an intermediate penalty for failing to do so. The penalty would be $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also is required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the Treasury regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, is treated as meeting the requirement that it not be a personal holding company.

De minimis rule for tenant service income (sec. 1052 of the bill and sec. 856(d) of the Code)

The bill permits a REIT to render a de minimis amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rent. The value of the impermissible services may not exceed one percent of the gross income from the property. For these purposes, the services may not be valued at less than 150 percent of the REIT's direct cost of the services.

Attribution rules applicable to tenant ownership (sec. 1053 of the bill and sec. 856(d)(5) of the Code)

The bill modifies the application of section 318(a)(3)(A) (attribution to partnerships) for purposes of defining rent in section 856(d)(2), so that attribution occurs only when a partner owns a 25 percent or greater interest in the partnership.

Credit for tax paid by REIT on retained capital gains (sec. 1054 of the bill and sec. 857(b)(3) of the Code)

The bill permits a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted under present law. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would be deemed to have paid the shareholder's share of the tax, which would be credited or refunded to the shareholder. Also, the basis of the shareholder's shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains.

Repeal of 30-percent gross income requirement (sec. 1055 of the bill and sec. 856(c) of the Code)

The bill repeals the rule that requires less than 30 percent of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than one year, certain real property held less than four years, and property that is sold or disposed of in a prohibited transaction.

Modification of earnings and profits for determining whether REIT has earnings and profits from non-REIT year (sec. 1056 of the bill and sec. 857(d) of the Code)

The bill changes the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years. Under the bill, distributions of accumulated earnings and profits generally are treated as made from the entity's earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits. These distributions are not treated as distributions for purposes of calculating the dividends paid deduction.

Treatment of foreclosure property (sec. 1057 of the bill and sec. 856(e) of the Code)

The bill lengthens the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also could be extended for an additional three years by filing a request to the IRS. Under the bill, a REIT could revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before its due date for filing its tax return.

In addition, the bill conforms the definition of independent contractor for purposes of the foreclosure property rule (sec. 856(e)(4)(C)) to the definition of independent contractor for purposes of the general rules (sec. 856(d)(2)(C)).

Payments under hedging instruments (sec. 1058 of the bill and sec. 856(c)(5)(G) of the Code)

The bill treats income from all hedges that reduce the interest rate risk of REIT liabilities, not just from interest rate swaps and caps, as qualifying income under the 95-percent test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) are treated as qualifying income for purposes of the 95-percent test.

Excess noncash income (sec. 1059 of the bill and sec. 857(e)(2) of the Code)

The bill (1) expands the class of excess noncash items that are not subject to the distribution requirement to include income from the cancellation of indebtedness and (2) extends the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.

Prohibited transaction safe harbor (sec. 1060 of the bill and sec. 856(b)(6)(C) of the Code)

The bill excludes from the prohibited sales rules property that was involuntarily converted.

Shared appreciation mortgages (sec. 10–61 of the bill and sec. 856(j) of the Code)

The bill provides that interest received on a shared appreciation mortgage is not subject to the tax on prohibited transactions where the property subject to the mortgage is sold within 4 years of the REIT's acquisition of the mortgage pursuant to a bankruptcy plan of the mortgagor unless the REIT that acquired the mortgage knew or had reason to know that the property subject to the mortgage would be sold in a bankruptcy proceeding.

Wholly-owned REIT subsidiaries (sec. 1062 of the bill and sec. 856(i)(2) of the Code)

The bill permits any corporation wholly-owned by a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. Where the REIT acquired an existing corporation, the bill treats any such corporation as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the normal rules of section 337). In addition, any pre-REIT earnings and profits of the subsidiary must be distributed before the end of the REIT's taxable year.

Effective Date

The bill is effective for taxable years beginning after the date of enactment.

E. Repeal of the 30-percent ("Short-short") Test for Regulated Investment Companies (sec. 1071 of the Bill and sec. 851(b)(3) of the Code)

Present Law

To qualify as a Regulated Investment Company (RIC), a company must derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than 3 months (the "30-percent test" or "short-short rule").

Reasons for Change

The short-short rule restricts the investment flexibility of RICs. The rule can, for example, limit a RIC's ability to "hedge" its investments (e.g., to use options to protect against adverse market moves).

The rule also burdens a RIC with significant recordkeeping, compliance, and administration costs. The RIC must keep track of the holding periods of assets and the relative percentages of short-term gain that it realizes throughout the year. The committee believes that the short-short test places unnecessary limitations upon a RIC's activities.

Explanation of Provision

The 30-percent test (or short-short rule) is repealed.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

F. Taxpayer Protections

1. Provide reasonable cause exception for additional penalties (sec. 1081 of the bill and secs. 6652, 6683, 7519 of the Code)

Present Law

Many penalties in the Code may be waived if the taxpayer establishes reasonable cause. For example, the accuracy-related penalty (sec. 6662) may be waived with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith (sec. 6664(c)).

Reasons for Change

The Committee believes that it is appropriate to provide a reasonable cause exception for several additional penalties where one does not currently exist.

Explanation of Provision

The bill provides that the following penalties may be waived if the failure is shown to be due to reasonable cause and not willful neglect:

(1) the penalty for failure to make a report in connection with deductible employee contributions to a retirement savings plan (sec. 6652(g));

(2) the penalty for failure to make a report as to certain small business stock (sec. 6652(k));

(3) the penalty for failure of a foreign corporation to file a return of personal holding company tax (sec. 6683); and

(4) the penalty for failure to make required payments for entities electing not to have the required taxable year (sec. 7519).

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

2. Clarification of period for filing claims for refunds (sec. 1082 of the bill and sec. 6512 of the Code)

Present Law

The Code contains a series of limitations on tax refunds. Section 6511 of the Code provides both a limitation on the time period in which a claim for refund can be made (section 6511(a)) and a limitation on the amount that can be allowed as a refund (section 6511(b)). Section 6511(a) provides the general rule that a claim for refund must be filed within 3 years of the date of the return or 2 years of the date of payment of the taxes at issue, whichever is later. Section 6511(b) limits the refund amount that can be covered: if a return was filed, a taxpayer can recover amounts paid within 2 years before the claim. Section 6512(b)(3) incorporates these rules where taxpayers who challenge deficiency notices in Tax Court are found to be entitled to refunds.

In *Commissioner* v. *Lundy,* 116 S. Ct. 647 (1996), the taxpayer had not filed a return, but received a notice of deficiency within 3 years after the date the return was due and challenged the proposed deficiency in Tax Court. The Supreme Court held that the taxpayer could not recover overpayments attributable to withholding during the tax year, because no return was filed and the 2-year "look back" rule applied. Since overwithheld amounts are deemed paid as of the date the taxpayer's return was first due (*i.e.,* more than 2 years before the notice of deficiency was issued), such overpayments could not be recovered. By contrast, if the same taxpayer had filed a return on the date the notice of deficiency was issued, and then claimed a refund, the 3-year "look back" rule would apply, and the taxpayer could have obtained a refund of the overwithheld amounts.

Reasons for Change

The Committee believes that it is appropriate to eliminate this disparate treatment.

Explanation of Provision

The bill permits taxpayers who initially fail to file a return, but who receive a notice of deficiency and file suit to contest it in Tax Court during the third year after the return due date, to obtain a refund of excessive amounts paid within the 3-year period prior to the date of the deficiency notice.

Effective Date

The provision applies to claims for refund with respect to tax years ending after the date of enactment.

3. Repeal of authority to disclose whether a prospective juror has been audited (sec. 1083 of the bill and sec. 6103 of the Code)

Present Law

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary must disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service (sec. 6103(h)(5)).

Reasons for Change

This disclosure requirement, as it has been interpreted by several recent court decisions, has created significant difficulties in the civil and criminal tax litigation process. First, the litigation process can be substantially slowed. It can take the Secretary a considerable period of time to compile the information necessary for a response (some courts have required searches going back as far as 25 years). Second, providing early release of the list of potential jurors to defendants (which several recent court decisions have required, to permit defendants to obtain disclosure of the information from the Secretary) can provide an opportunity for harassment and intimidation of potential jurors in organized crime, drug, and some tax protester cases. Third, significant judicial resources have been expended in interpreting this procedural requirement that might better be spent resolving substantive disputes. Fourth, differing judicial interpretations of this provision have caused confusion. In some instances, defendants convicted of criminal tax offenses have obtained reversals of those convictions because of failures to comply fully with this provision.

Explanation of Provision

The bill repeals the requirement that the Secretary disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.

Effective Date

The provision is effective for judicial proceedings commenced after the date of enactment.

4. Clarify statute of limitations for items from pass-through entities (sec. 1084 of the bill and sec. 6501 of the Code)

Present Law

Pass through entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due.

Some believe that, prior to 1993, it may have been unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or individual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). In 1993, the Supreme Court held that the limitations period for assessing the income tax liability of an S corporation shareholder runs from the date the shareholder's return is filed (*Bufferd* v. *Comm.,* 113 S. Ct. 927 (1993)).

Reasons for Change

Uncertainty regarding the correct statute of limitations hinders the resolution of factual and legal issues and creates needless litigation over collateral matters.

Explanation of Provision

The bill clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

5. Prohibition on browsing (secs. 1084 and 1085 of the bill and secs. 7213A and 7431 of the Code)

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized willful disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

There is no explicit criminal penalty in the Internal Revenue Code for unauthorized inspection (absent subsequent disclosure) of tax returns and return information. Such inspection is, however, explicitly prohibited by the Internal Revenue Service ("IRS").[140] In a recent case, an individual was convicted of violating the Federal wire fraud statute (18 U.S.C. 1343 and 1346) and a Federal computer fraud statute (18 U.S.C. 1030) for unauthorized inspection. However, the U.S. First Circuit Court of Appeals overturned this conviction.[141] Unauthorized inspection of information of any department or agency of the United States (including the IRS) via computer was made a crime under 18 U.S.C. 1030 by the Economic Espionage Act of 1996.[142] This provision does not apply to unauthorized inspection of paper documents.

Reasons for Change

The Committee believes that it is important to have a criminal penalty in the Internal Revenue Code to punish this type of behavior. The Committee also believes that it is appropriate to provide for civil damages for unauthorized inspection parallel to civil damages for unauthorized disclosure.

Explanation of Provisions

Criminal penalties

The bill creates a new criminal penalty in the Internal Revenue Code. The penalty is imposed for willful inspection (except as authorized by the Code) of any tax return or return information by any Federal employee or IRS contractor. The penalty also applies to willful inspection (except as authorized) by any State employee or other person who acquired the tax return or return information under specific provisions of section 6103. Upon conviction, the penalty is a fine in any amount not exceeding $1,000,[143] or imprisonment of not more than 1 year, or both, together with the costs of

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[140] IRS Declaration of Privacy Principles, May 9, 1994.
[141] *U.S.* v. *Czubinski,* DTR 2/25/97, p. K–2.
[142] P.L. 104–294, sec. 201 (October 11, 1996).
[143] Pursuant to 18 U.S.C. sec. 3571 (added by the Sentencing Reform Act of 1984), the amount of the fine is not more than the greater of the amount specified in this new Code section or $100,000.

prosecution. In addition, upon conviction, an officer or employee of the United States would be dismissed from office or discharged from employment.

The Congress views any unauthorized inspection of tax returns or return information as a very serious offense; this new criminal penalty reflects that view. The Congress also believes that unauthorized inspection warrants very serious personnel sanctions against IRS employees who engage in unauthorized inspection, and that it is appropriate to fire employees who do this.

Civil damages

The bill amends the provision providing for civil damages for unauthorized disclosure by also providing for civil damages for unauthorized inspection. Damages are available for unauthorized inspection that occurs either knowingly or by reason of negligence. Accidental or inadvertent inspection that may occur (such as, for example, by making an error in typing in a TIN) would not be subject to damages because it would not meet this standard. The bill also provides that no damages are available to a taxpayer if that taxpayer requested the inspection or disclosure.

The bill also requires that, if any person is criminally charged by indictment or information with inspection or disclosure of a taxpayer's return or return information in violation of section 7213(a) or (b), section 7213A (as added by the bill), or 18 USC section 1030(a)(2)(B), the Secretary notify that taxpayer as soon as practicable of the inspection or disclosure.

Effective Date

The bill is effective for violations occurring on or after the date of enactment.

TITLE XI. ESTATE, GIFT, AND TRUST TAX SIMPLIFICATION

1. Eliminate gift tax filing requirements for gifts to charities (sec. 1101 of the bill and sec. 6019 of the Code)

Present Law

A gift tax generally is imposed on lifetime transfers of property by gift (sec. 2501). In computing the amount of taxable gifts made during a calendar year, a taxpayer generally may deduct the amount of any gifts made to a charity (sec. 2522). Generally, this charitable gift deduction is available for outright gifts to charity, as well as gifts of certain partial interests in property (such as a remainder interest). A gift of a partial interest in property must be in a prescribed form in order to qualify for the deduction.

Individuals who make gifts in excess of $10,000 to any one donee during the calendar year generally are required to file a gift tax return (sec. 6019). This filing requirement applies to all gifts, whether charitable or noncharitable, and whether or not the gift qualifies for a gift tax charitable deduction. Thus, under current law, a gift tax return is required to be filed for gifts to charity in excess of $10,000, even though no gift tax is payable on the transfer.

Reasons for Change

Because a charitable gift does not give rise to a gift tax liability, many donors are unaware of the requirement to file a gift tax return for charitable gifts in excess of $10,000. Failure to file a gift tax return under these circumstances could expose the donor to penalties. The bill eliminates this potential trap for the unwary.

Explanation of Provision

The bill provides that gifts to charity are not subject to the gift tax filing requirements of section 6019, as long as the entire value of the transferred property qualifies for the gift tax charitable deduction under section 2522. The filing requirements for gifts of partial interests in property remain unchanged.

Effective Date

The provision is effective for gifts made after the date of enactment.

2. Clarification of waiver of certain rights of recovery (sec. 1102 of the bill and secs. 2207A and 2207B of the Code)

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate upon his or her death. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to inclusion of QTIP from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). For this purpose, a will provision specifying that all taxes shall be paid by the estate is sufficient to waive the right of recovery.

A decedent's gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income (sec. 2036). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207B). This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

Reasons for Change

It is understood that persons utilizing standard testamentary language often inadvertently waive the right of recovery with respect to QTIP. Similarly, persons waiving a right to contribution are unlikely to refer to the code section granting the right. Accordingly, allowing the right of recovery (or right of contribution) to be waived only by specific reference should simplify the drafting of wills by better conforming with the testator's likely intent.

Explanation of Provision

The bill provides that the right of recovery with respect to QTIP is waived only to the extent that language in the decedent's will or revocable trust specifically so indicates (e.g., by a specific reference to QTIP, the QTIP trust, section 2044, or section 2207A). Thus, a general provision specifying that all taxes be paid by the estate is no longer sufficient to waive the right of recovery.

The bill also provides that the right of contribution for property over which the decedent retained enjoyment or the right to income is waived by a specific indication in the decedent's will or revocable trust, but specific reference to section 2207B is no longer required.

Effective Date

The provision applies to decedents dying after the date of enactment.

3. Transitional rule under section 2056A (sec. 1103 of the bill and sec. 2056A of the Code)

Present Law

A "marital deduction" generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") denied the marital deduction for property passing to an alien spouse outside a qualified domestic trust ("QDT"). An estate tax generally is imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust that, among other things, required all trustees be U.S. citizens or domestic corporations. This provision was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to require that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").

Reasons for Change

Wills drafted under the TAMRA rules must be revised to conform with the withholding requirement, even though both the TAMRA rule and its successor ensure that a U.S. trustee is personally liable for the estate tax on a QDT. Reinstatement of the TAMRA rule for wills drafted in reliance upon it reduces the number of will revisions necessary to comply with statutory changes, thereby simplifying estate planning.

Explanation of Provision

Certain trusts created before the enactment of the Omnibus Budget Reconciliation Act of 1990 are treated as satisfying the withholding requirement if the governing instruments require that all trustees be U.S. citizens or domestic corporations.

Effective Date

The provision applies as if included in the Omnibus Budget Reconciliation Act of 1990.

4. Treatment for estate tax purposes of short-term obligations held by nonresident aliens (sec. 1104 of the bill and sec. 2105 of the Code)

Present Law

The United States imposes estate tax on assets of noncitizen nondomiciliaries that were situated in the United States at the time of the individual's death. Debt obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia are considered property located within the United States if held by a nonresident not a citizen of the United States (sec. 2014(c)).

Special rules apply to treat certain bank deposits and debt instruments the income from which qualifies for the bank deposit interest exemption and the portfolio interest exemption as property from without the United States despite the fact that such items are obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia (sec. 2105(b)). Income from such items is exempt from U.S. income tax in the hands of the nonresident recipient (secs. 871(h) and 871(i)(2)(A)). The effect of these special rules is to exclude these items from the U.S. gross estate of a nonresident not a citizen of the United States. However, because of an amendment to section 871(h) made by the Tax Reform Act of 1986, these special rules no longer cover obligations that generate short-term OID income despite the fact that such income is exempt from U.S. income tax in the hands of the nonresident recipient (sec. 871(g)(1)(B)(i)).

Reasons for Change

The Committee believes that the income and estate tax treatments of short-term OID obligations held by nonresident aliens should conform. A purpose of exempting short-term OID income derived by nonresident aliens from U.S. income tax is to enhance the ability of U.S. borrowers to raise funds from foreign lenders, and such purpose is hindered by the lack of a corresponding exemption for U.S. estate tax. Moreover, to the extent the interest from such an obligation is exempt from U.S. income tax, the inclusion of the instrument in the nonresident noncitizen's U.S. estate would be a trap for the unwary.

Explanation of Provision

The bill provides that any debt obligation, the income from which would be eligible for the exemption for short-term OID under section 871(g)(1)(B)(i) if such income were received by the decedent on the date of his death, is treated as property located outside of the United States in determining the U.S. estate tax liability of a nonresident not a U.S. citizen. No inference is intended with respect to the estate tax treatment of such obligations under present law.

Effective Date

The provision is effective for estates of decedents dying after the date of enactment.

5. Distributions during first 65 days of taxable year of estate (sec. 1105 of the bill and sec. 663(b) of the Code)

Present Law

In general, trusts and estates are treated as conduits for Federal income tax purposes; income received by a trust or estate that is distributed to a beneficiary in the trust or estate's taxable year "ending with or within" the taxable year of the beneficiary is taxable to the beneficiary in that year; income that is retained by the trust or estate is initially taxable to the trust or estate. In the case of distributions of previously accumulated income by trusts (but not estates), there may be additional tax under the so-called "throwback" rules if the beneficiary to whom the distributions were made has marginal rates higher than those of the trust. Under the "65-day rule," a trust may elect to treat distributions paid within 65 days after the close of its taxable year as paid on the last day of its taxable year. The 65-day rule is not applicable to estates.

Reasons for Change

In order to minimize the tax differences between estates and revocable trusts, the Committee believes that the 65-day rule should be allowed to estates as well as to trusts.

Explanation of Provision

The bill extends application of the 65-day rule to distributions by estates. Thus, an executor can elect to treat distributions paid within 65 days after the close of the estate's taxable year as having been paid on the last day of such taxable year.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

6. Separate share rules available to estates (sec. 1106 of the bill and sec. 663(c) of the Code)

Present Law

Trusts with more than one beneficiary must use the "separate share" rule in order to provide different tax treatment of distributions to different beneficiaries to reflect the income earned by different shares of the trust's corpus.[144] Treasury regulations provide that "[t]he application of the separate share rule * * * will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. * * * Separate share treatment will not be applied to a trust or portion of a trust subject to a power to distribute, apportion, or accumulate income or distribute corpus to or for the use of one or more beneficiaries within a group or class of beneficiaries, unless the payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made under the governing instrument so that substantially separate and independent shares exist." (Treas. Reg. sec. 1.663(c)–3). The separate share rule presently does not apply to estates.

Reasons for Change

The Committee understands that estates typically do not have separate shares. Nonetheless, where separate shares do exist in an estate, the inapplicability of the separate share rule to estates may result in one beneficiary or class of beneficiaries being taxed on income payable to, or accruing to, a separate beneficiary or class of beneficiaries. Accordingly, the Committee believes that a more equitable taxation of an estate and its beneficiaries would be achieved with the application of the separate share rule to an estate where, under the provisions of the decedent's will or applicable local law, there are separate shares in the estate.

Explanation of Provision

The bill extends the application of the separate share rule to estates. There are separate shares in an estate when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries. For example, a separate share in an estate would exist where the decedent's will provides that all of the shares of a closely-held corporation are devised to one beneficiary and that any dividends paid to the estate by that corporation should be paid only to that beneficiary and any such dividends would not affect any other amounts which that beneficiary would

[144] Application of the separate share rule is not elective; it is mandatory if there are separate shares in the trust.

receive under the will. As in the case of trusts, the application of the separate share rule is mandatory where separate shares exist.

Effective Date

The provision applies to decedents dying after the date of enactment.

7. Executor of estate and beneficiaries treated as related persons for disallowance of losses (sec. 1107 of the bill and secs. 267(b) and 1239(b) of the Code)

Present Law

Section 267 disallows a deduction for any loss on the sale of an asset to a person related to the taxpayer. For the purposes of section 267, the following parties are related persons: (1) a trust and the trust's grantor, (2) two trusts with the same grantor, (3) a trust and a beneficiary of the trust, (4) a trust and a beneficiary of another trust, if both trusts have the same grantor, and (5) a trust and a corporation the stock of which is more than 50 percent owned by the trust or the trust's grantor.

Section 1239 disallows capital gain treatment on the sale of depreciable property to a related person. For purposes of section 1239, a trust and any beneficiary of the trust are treated as related persons, unless the beneficiary's interest is a remote contingent interest.

Neither section 267 nor section 1239 presently treat an estate and a beneficiary of the estate as related persons.

Reasons for Change

The Committee believes that the disallowance rules under sections 267 and 1239 with respect to transactions between related parties should apply to an estate and a beneficiary of that estate for the same reasons that such rules apply to a trust and a beneficiary of that trust.

Explanation of Provision

Under the bill, an estate and a beneficiary of that estate are treated as related persons for purposes of sections 267 and 1239, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

8. Simplified taxation of earnings of pre-need funeral trusts (sec. 1108 of the bill and sec. 684 of the Code)

Present Law

A pre-need funeral trust is an arrangement where an individual purchases funeral or burial services or merchandise from a funeral home or cemetery in advance of the individual's death. The individual enters into a contract with the provider of such services or merchandise whereby the individual selects the services or merchandise to be provided upon his or her death, and agrees to pay for them in advance of his or her death. Such amounts (or a portion thereof) are held in trust during the individual's lifetime and are paid to the seller upon the individual's death.

Under present law, pre-need funeral trusts generally are treated as grantor trusts, and the annual income earned by such trusts is taxed to the purchaser/grantor of the trust. Rev. Rul. 87–127. Any amount received from the trust by the seller (as payment for services or merchandise) is includible in the gross income of the seller.

Reasons for Change

To the extent that pre-need funeral trusts are treated as grantor trusts under present law, numerous individual taxpayers are required to account for the earnings of such trusts on their tax returns, even though the earnings with respect to any one taxpayer may be small. The Committee believes that this recordkeeping burden on individuals could be eased, and that compliance with the tax laws would be improved, if such trusts instead were taxed at the entity level, with one simplified annual return filed by the trustee reporting the aggregate income from all such trusts administered by the trustee.

Explanation of Provision

The bill allows the trustee of a pre-need funeral trust to elect special tax treatment for such a trust, to the extent the trust would otherwise be treated as a grantor trust. A qualified funeral trust is defined as one which meets the following requirements: (1) the trust arises as the result of a contract between a person engaged in the trade or business of providing funeral or burial services or merchandise and one or more individuals to have such services or property provided upon such individuals' death; (2) the only beneficiaries of the trust are individuals who have entered into contracts to have such services or merchandise provided upon their death; (3) the only contributions to the trust are contributions by or for the benefit of the trust beneficiaries; (4) the trust's only purpose is to hold and invest funds that will be used to make payments for funeral or burial services or merchandise for the trust beneficiaries; and (5) the trust has not accepted contributions totaling more than $7,000 by or for the benefit of any individual. For this purpose, "contributions" include all amounts transferred to the trust, regardless of how denominated in the contract. Contributions do not, however, include income or gain earned with respect to property in the trust. For purposes of applying the $7,000 limit, if a purchaser has more than one contract with a single trustee (or related trustees), all such trusts are treated as one trust. Similarly, if the Secretary of Treasury determines that a purchaser has entered into separate contracts with unrelated trustees to avoid the $7,000 limit described above, the Secretary may require that such trusts be treated as one trust. For contracts entered into after 1998, the $7,000 limit is indexed annually for inflation.

The trustee's election to have this provision apply to a qualified funeral trust is to be made separately with respect to each purchaser's trust. It is anticipated that the Department of Treasury will issue prompt guidance with respect to the simplified reporting requirements so that if the election is made, a single annual trust return may be filed by the trustee, separately listing the amount of income earned with respect to each purchaser. If the election is made, the trust is not treated as a grantor trust and the amount of tax paid with respect to each purchaser's trust is determined in accordance with the income tax rate schedule generally applicable to estates and trusts (Code sec. 1(e)), but no deduction is allowed under section 642(b). The tax on the annual earnings of the trust is payable by the trustee.

As under present law, amounts received from the trust by the seller are treated as payments for services and merchandise and are includible in the gross income of the seller. No gain or loss is recognized to the beneficiary of the trust for payments from the trust to the beneficiary upon cancellation of the contract, and the beneficiary takes a carryover basis in any assets received from the trust upon cancellation.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

9. Adjustments for gifts within three years of decedent's death (sec. 1109 of the bill and secs. 2035 and 2038 of the Code)

Present Law

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke the transfer (sec. 2038). The gross estate also includes the value of any property with respect to which such power is relinquished during the three years before death (sec. 2035). There has been significant litigation as to whether these rules require that certain transfers made from a revocable trust within three years of death be includible in the gross estate. See, e.g., *Jalkut Estate* v. *Commissioner*, 96 T.C. 675 (1991) (transfers from revocable trust includible in gross estate); *McNeely* v. *Commissioner*, 16 F.3d 303 (8th Cir. 1994) (transfers from revocable trust not includible in gross estate); *Kisling* v. *Commissioner*, 32 F.3d 1222 (8th Cir. 1994) (acq.) (transfers from revocable trust not includible in gross estate).

Reasons for Change

The inclusion of certain property transferred during the three years before death is directed at transfers that would otherwise reduce the amount subject to estate tax by more than the amount subject to gift tax, disregarding appreciation between the times of gift and death. Because all amounts transferred from a revocable trust are subject to the gift tax, the Committee believes that inclusion of such amounts is unnecessary where the transferor has retained no power over the property transferred out of the trust. The Committee believes that clarifying these rules statutorily will lend certainty to these rules.

Explanation of Provision

The provision codifies the rule set forth in the *McNeely* and *Kisling* cases to provide that a transfer from a revocable trust (i.e., a trust described under section 676) is treated as if made directly by the grantor. Thus, an annual exclusion gift from such a trust is not included in the gross estate.

The provision also revises section 2035 to improve its clarity.

Effective Date

The provision applies to decedents dying after the date of enactment

10. Clarify relationship between community property rights and retirement benefits (sec. 1110 of the bill and sec. 2056(b)(7)(C) of the Code)

Present Law

Community property

Under state community property laws, each spouse owns an undivided one-half interest in each community property asset. In community property jurisdictions, a nonparticipant spouse may be treated as having a vested community property interest in either his or her spouse's qualified plan, individual retirement arrangement ("IRA"), or simplified employee pension ("SEP") plan.

Transfer tax treatment of qualified plans

In the Retirement Equity Act of 1984 ("REA"), qualified retirement plans were required to provide automatic survivor benefits (1) in the case of a participant who retires under the plan, in the form of a qualified joint and survivor annuity, and (2) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, in the form of a preretirement survivor annuity. A participant generally is permitted to waive such annuities, provided he or she obtains the written consent of his or her spouse.

The Tax Reform Act of 1986 repealed the estate tax exclusion, formerly contained in sections 2039(c) and 2039(d), for certain interests in qualified plans owned by a nonparticipant spouse attributable to community property laws and made certain other changes to conform the transfer tax treatment of qualified and nonqualified plans.

As a result of these changes made by REA and the Tax Reform Act of 1986, the transfer tax treatment of married couples residing in a community property state is unclear where either spouse is covered by a qualified plan.

Reasons for Change

The Committee believes that survivorship interests in annuities in community property States should be accorded similar treatment to the tax treatment of interests in such annuities in non-community property States. Accordingly, the bill would clarify that the transfer at death of a survivorship interest in an annuity to a surviving spouse will be a deductible marital transfer under the QTIP rules regardless of whether the decedent's annuity interest arose out of his or her employment or arose under community property laws by reason of the employment of his or her spouse.

Explanation of Provision

The bill clarifies that the marital deduction is available with respect to a nonparticipant spouse's interest in an annuity attributable to community property laws where he or she predeceases the participant spouse. Under the bill, the nonparticipant spouse's interest in an annuity arising under the community property laws of a State that passes to the surviving participant spouse may qualify for treatment as QTIP under section 2056(b)(7).

The provision is not intended to create an inference regarding the treatment under present law of a transfer to a surviving spouse of the decedent spouse's interest in an annuity arising under community property laws.

Effective Date

The provision applies to decedents dying, or waivers, transfers and disclaimers made, after the date of enactment.

11. Treatment under qualified domestic trust rules of forms of ownership which are not trusts (sec. 1111 of the bill and sec. 2056A(c) of the Code)

Present Law

A marital deduction generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. The marital deduction is not available for property passing to an alien spouse outside a qualified domestic trust ("QDT"). An estate tax generally is imposed on corpus distributions from a QDT.

Trusts are not permitted in some countries (e.g., many civil law countries).[145] As a result, it is not possible to create a QDT in those countries.

Description of Proposal

The proposal would provide the Treasury Department with regulatory authority to treat as trusts legal arrangements that have substantially the same effect as a trust.

[145] Note that in some civil law States (e.g., Louisiana) an entity similar to a trust, called a usufruct, exits.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

12. Opportunity to correct certain failures under section 2032A (sec. 1112 of the bill and sec. 2032A of the Code)

Present Law

For estate tax purposes, an executor may elect to value certain real property used in farming or other closely held business operations at its current use value rather than its highest and best use (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

Treasury regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A–8). The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

Under procedures prescribed by the Treasury Department, an executor who makes the election and substantially complies with the regulations but fails to provide all required information or the signatures of all persons with an interest in the property may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Treasury Department.

Reasons for Change

It is understood that executors commonly fail to include with the filed estate tax return a recapture agreement signed by all persons with an interest in the property or all information required by Treasury regulations. It is believed that allowing such signatures or information to be supplied later is consistent with the legislative intent of section 2032A and eases return filing.

Explanation of Provision

The bill extends the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to compliance with the Treasury regulations. Thus, the bill allows the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. During that time period, the bill also allows the addition of signatures to a previously filed agreement.

Effective Date

The provision applies to decedents dying after the date of enactment.

13. Authority to waive requirement of U.S. trustee for qualified domestic trusts (sec. 1113 of the bill and sec. 2056A(a)(1)(A) of the Code)

Present Law

In order for a trust to be a QDT, a U.S. trustee must have the power to approve all corpus distributions from the trust. In some countries, trusts cannot have any U.S. trustees. As a result, trusts established in those countries cannot qualify as a QDT.

Reasons for Change

The estate of a decedent with a nonresident spouse should not be precluded from qualifying for the marital deduction in situations where the use of a U.S. trustee is prohibited by another country. Accordingly, the Committee believes it is appropriate to grant regulatory authority to allow qualification for the marital deduction in such situations where the Treasury Department determines that the U.S. can retain jurisdiction and other adequate security has been provided for the payment of U.S. transfer taxes on subsequent transfers by the surviving spouse of the property transferred by the decedent.

Explanation of Provision

In order to permit the establishment of a QDT in those situations where a country prohibits a trust from having a U.S. trustee, the bill provides the Treasury Department with regulatory authority to waive the requirement that a QDT have a U.S. trustee. It is anticipated that such regulations, if any, provide an alternative mechanism under which the U.S. would retain jurisdiction and adequate security to impose U.S. transfer tax on transfers by the surviving spouse of the property transferred by the decedent. For example, one possible mechanism would be a closing agreement process under which the surviving spouse waives treaty benefits, allows the U.S. to retain taxing jurisdiction and provides adequate security with respect to such transfer taxes.

Effective Date

The provision applies to decedents dying after the date of enactment.

TITLE XII. EXCISE TAX AND OTHER SIMPLIFICATION PROVISIONS

A. Increase De Minimis Limit for After-Market Alterations Subject to Heavy Truck and Luxury Automobile Excise Taxes (sec. 1201 of the bill and secs. 4001 and 4051 of the Code)

Present Law

An excise tax is imposed on retail sales of truck chassis and truck bodies suitable for use in a vehicle with a gross vehicle weight of over 33,000 pounds. The tax is equal to 12 percent of the retail sales price. An excise tax also is imposed on retail sales of luxury automobiles. The tax currently is equal to 8 percent of the amount by which the retail sales price exceeds an inflation-adjusted $30,000 base. (The rate is reduced by 1 percentage point per year through 2002, and the tax is not imposed after 2002.) Anti-abuse rules prevent the avoidance of these taxes through separate purchases of major component parts. With certain exceptions, tax at the rate applicable to the vehicle is imposed on the subsequent installation of parts and accessories within six months after purchase of a taxable vehicle. The exceptions include a *de minimis* exception for parts and accessories with an aggregate price that does not exceed $200 (or such other amount as Treasury may by regulation prescribe).

Reasons for Change

Retailers generally are responsible for taxes on truck chassis and bodies and luxury automobiles. In the case of a subsequent installation, however, the owner or operator of the vehicle is responsible for paying the tax attributable to the installation and the installer is secondarily liable. Increasing the *de minimis* amount should significantly reduce the number of return filers and relieve many persons from the administrative burden of filing an excise tax return reporting a very small amount of tax.

Explanation of Provision

The tax on subsequent installation of parts and accessories does not apply to parts and accessories with an aggregate price that does not exceed $1,000. Parts and accessories installed on a vehicle on or before that date are taken into account in determining whether the $1,000 threshold is exceeded. If the aggregate price of the pre-effective date parts and accessories does not exceed $200, they are not subject to tax unless the aggregate price of all additions exceeds $1,000.

Effective Date

The increase in the threshold for taxing after-market additions under the heavy truck and luxury car excise taxes is effective on January 1, 1998.

B. Simplification of Excise Taxes on Distilled Spirits, Wine, and Beer (secs. 1211-1222 of the bill and secs. 5008, 5053, 5055, 5115, 5175, and 5207, and new secs. 5222 and 5418 of the Code)

Present Law

Imported distilled spirits returned to plant.—Excise tax that has been paid on domestic distilled spirits is credited or refunded if the spirits are later returned to bonded premises. Tax is imposed on imported bottled spirits when they are withdrawn from customs custody, but the tax is not refunded or credited if the spirits are later returned to bonded premises.

Cancellation of export bonds.—An exporter that withdraws distilled spirits from bonded warehouses for export or transportation to a customs bonded warehouse without the payment of tax must furnish a bond to cover the withdrawal. The required bonds are canceled "on the submission of such evidence, records, and certification indicating exportation as the Secretary may by regulations prescribe."

Location of records of distilled spirits plant.— Proprietors of distilled spirits plants are required to maintain records and reports relating to their production, storage, denaturation, and processing activities on the premises where the operations covered by the record are carried on.

Transfers from brewery to distilled spirits plant.—A distilled spirits plant may receive on its bonded premises beer to be used in the production of distilled spirits only if the beer is produced on contiguous brewery premises.

Sign not required for wholesale dealers.—Wholesale liquor dealers are required to post a sign identifying the firm as such. Failure to do so is subject to a penalty.

Refund on returns of merchantable wine.—Excise tax paid on domestic wine that is returned to bond as unmerchantable is refunded or credited, and the wine is once again treated as wine in bond on the premises of a bonded wine cellar.

Increased sugar limits for certain wine.—Natural wines may be sweetened to correct high acid content. For most wines, however, sugar cannot constitute more than 35 percent (by volume) of the combined sugar and juice used to produce the wine. Up to 60 percent sugar may be used in wine made from loganberries, currants, and gooseberries. If the amount of sugar used exceeds the applicable limitation, the wine must be labeled "substandard."

Beer withdrawn for embassy use.—Imported beer to be used for the family and official use of representatives of foreign governments or public international organizations may be withdrawn from customs bonded warehouses without payment of excise tax. No similar exemption applies to domestic beer withdrawn from a brewery or entered into a bonded customs warehouse for the same authorized use.

Beer withdrawn for destruction.—Removals of beer from a brewery are exempt from tax if the removal is for export, because the beer is unfit for beverage use, for laboratory analysis, research, development and testing, for the brewer's personal or family use, or as supplies for certain vessels and aircraft.

Drawback on exported beer.—A domestic producer that exports beer may recover the tax (receive a "drawback") found to have been paid on the exported beer upon the "submission of such evidence, records and certificates indicating exportation" required by regulations.

Imported beer transferred in bulk to brewery and imported wine transferred in bulk to wineries.—Imported beer and wine are subject to tax when removed from customs custody.

Reasons for Change

Until 1980, the method of collecting alcohol excise taxes required the regular presence of Treasury Department inspectors at alcohol production facilities. In 1980, the method of collecting tax was changed to a bonded premises system under which examinations and collection procedures are similar to those used in connection with other Federal excise taxes.

A number of reporting and recordkeeping requirements need to be modified to conform to the current collection system. Appropriate modification will allow the Bureau of Alcohol, Tobacco and Firearms to administer alcohol excise taxes more efficiently and relieve taxpayers of unnecessary paperwork burdens.

The current rules under which the Code permits tax-free removals of alcoholic beverages (or allows a credit or refund of tax on a return to bonded premises) result in inappropriate disparities in the treatment of different types of alcoholic beverages. In addition, these rules unduly limit available options for complying with environmental and other laws that regulate the destruction and disposition of alcoholic beverages. Under the bonded premises system, these rules scan be liberalized without jeopardizing the collection of tax revenues.

Other provisions of current law (i.e., the sign requirement and the sugar limits for certain wine) are outdated and should be repealed or revised.

Explanation of Provisions

Imported distilled spirits returned to plant.—Refunds or credits of the tax are available for imported bottled spirits that are returned to distilled spirits plants.

Cancellation of export bonds.—The certification requirements are relaxed to allow the bonds to be canceled if there is such proof of exportation as the Secretary may require.

Location of records of distilled spirits plant.—Records and reports are permitted to be maintained elsewhere other than on the plant premises

Transfers from brewery to distilled spirits plant.—Beer may be brought from any brewery for use in the production of spirits. Such beer is exempt from excise tax, subject to Treasury regulations.

Sign not required for wholesale dealers.—The requirement that a sign be posted is repealed.

Refund on returns of merchantable wine.—A refund or credit is available in the case of all domestic wine returned to bond, whether or not unmerchantable.

Increased sugar limits for certain wine.—Up to 60 percent sugar is permitted in any wine made from juice, such as cranberry or plum juice, with an acid content of 20 or more parts per thousand.

Beer withdrawn for embassy use.—Subject to Treasury's regulatory authority, an exemption similar to that currently available for imported beer is provided for domestic beer.

Beer withdrawn for destruction.—An exemption from tax is added for removals for destruction, subject to Treasury regulations.

Drawback on exported beer.—The certification requirement is relaxed to allow a drawback of tax paid if there is such proof of exportation as the Secretary may by regulations require.

Imported beer transferred in bulk to brewery and imported wine transferred in bulk to wineries.—Subject to Treasury regulations, beer and wine imported in bulk may be withdrawn from customs custody and transferred in bulk to a brewery (beer) or a winery (wine) without payment of tax. The proprietor of the brewery to which the beer is transferred or of the winery to which the wine is transferred is liable for the tax imposed on the withdrawal from customs custody and the importer is relieved of liability.

Effective Date

The provision to repeal the requirement that wholesale liquor dealers post a sign outside their place of business takes effect on the date of enactment. The other provisions take effect on the first day of the calendar quarter that begins at least 90 days after the date of enactment.

C. Other Excise Tax Provisions

1. Authority for Internal Revenue Service to grant exemptions from excise tax registration requirements (sec. 1231 of the bill and sec. 4222 of the Code)

Present Law

The Code exempts certain types of sales (e.g., sales for use in further manufacture, sales for export, and sales for use by a State or local government or a nonprofit educational organization) from excise taxes imposed on manufacturers and retailers. These exemptions generally apply only if the seller, the purchaser, and any person to whom the article is resold by the purchaser (the second purchaser) are registered with the Internal Revenue Service. The IRS can waive the registration requirement for the purchaser and second purchaser in some but not all cases.

Reasons for Change

Allowing the Internal Revenue Service to waive the registration requirement for purchasers and second purchasers in all cases will permit more efficient administration of the exemptions and reduce paperwork burdens on taxpayers.

Explanation of Provision

The IRS is authorized to waive the registration requirement for purchasers and second purchasers in all cases.

Effective Date

The provision applies to sales made pursuant to waivers issued after the date of enactment.

2. Repeal of excise tax deadwood provisions (sec. 1232 of the bill and secs. 4051, 4495–4498, and 4681–4682 of the Code)

Present Law

The Code includes a provision relating to a temporary reduction in the tax on piggyback trailers sold before July 18, 1985, and provisions relating to the tax on the removal of hard minerals from the deep seabed before June 28, 1990.

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (sec. 4681). The amount of the tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount was $5.80 per pound in 1996 and will increase by 45 cents per pound per year thereafter. The Code contains provisions for special rates of tax applicable to years before 1996 (e.g., sec. 4282(g) (1), (2), (3), and (5)).

Reasons for Change

The elimination of out-of-date, "deadwood" provisions will simplify the Code by removing unneeded Code sections.

Explanation of Provision

These provisions are repealed, as deadwood.

Effective Date

The provisions are effective on the date of enactment.

3. Modifications to excise tax on certain arrows (sec. 1233 of the bill and sec. 4161 of the Code)

Present Law

An 11-percent manufacturer's excise tax is imposed on bows having a draw weight of more than 10 pounds and on arrows that either are greater than 18 inches in length or are suitable for use with a taxable bow. The tax is imposed on the manufacturer's sales price of the completed arrow.

Reasons for Change

Imposing the excise tax on the component parts of the arrow before they are shipped to the assembler of the arrow will improve compliance with, and collection of, the tax by reducing the potential number of tax collection points.

Explanation of Provision

Under the bill, the current excise tax on arrows tax is replaced with a manufacturer's excise tax on the four component parts of the arrow: shafts, points, nocks, and vanes. The tax rate is increased to 12.4 percent of the value of each of these four components to offset the reduction in aggregate value subjected to tax compared to present-law valuation of the completed arrow.

Effective Date

The provision is effective for arrow components sold after September 30, 1997.

4. Modifications to heavy highway vehicle retail excise tax (sec. 1234 of the bill and sec. 4051 of the Code)

Present Law

A 12-percent retail excise tax is imposed on certain heavy highway trucks and trailers, and on highway tractors. Small trucks (those with a gross vehicle weight not over 33,000 pounds) and lighter trailers (those with a gross vehicle weight not over 26,000 pounds) are exempt from the tax. The tax applies to the first retail sale of a new or remanufactured vehicle. The determination under present law of whether a particular modification to an existing vehicle constitutes remanufacture (taxable) or a repair (nontaxable) is factual and generally is based on whether the function of the vehicle is changed or, in the case of worn vehicles, whether the cost of the modification exceeds 75 percent of the value of the modified vehicle.

No tax is imposed on trucks, tractors, and trailers when they are sold for resale or long-term lease, if the purchaser is registered with the Treasury Department. In such cases, purchasers are liable for the tax when the vehicle is sold or leased. The tax is based on the sales price in the transaction to which it applies.

Reasons for Change

Clarification is needed concerning the application of the 75-percent-of value threshold in determining whether repairs to a wrecked vehicle constitutes remanufacture. A certification requirement for resales of trucks, tractors, and trailers will simplify administration of the tax.

Explanation of Provision

The bill makes two changes to the heavy vehicle excise tax:

(1) Clarification is provided that the 75-percent-of-value threshold applies in determining whether repairs to a wrecked vehicle constitute remanufacture; and

(2) The registration requirement currently applicable to certain sales of trucks, tractors, and trailers for resale is replaced with a certification requirement.

Effective Date

The provision is effective after December 31, 1997.

5. Treatment of skydiving flights as noncommercial aviation (sec. 1235 of the bill and sec. 4081 and 4261 of the Code)

Present Law

Commercial passenger aviation, or air transportation for which a fare is charged, is subject to a 10-percent *ad valorem* excise tax for the Airport and Airway Trust Fund. General aviation, or air transportation which is not "for hire" is subject to a fuels tax for the Trust Fund. In the case of skydiving flights, questions have arisen as to when the flight is commercial aviation subject to the ticket tax and when it is noncommercial aviation subject to the fuels tax. In general, if instruction is offered, the flight is general aviation. Otherwise, the flight is treated as commercial aviation. Many skydiving flights carry both persons receiving instruction and others not receiving instruction.

Reasons for Change

The tax treatment of skydiving flights as commercial or noncommercial needs to be clarified.

Explanation of Provision

The bill specifies that flights which are exclusively dedicated to skydiving are taxed as noncommercial aviation flights, regardless of whether instruction is offered to any of the passengers.

Effective Date

The provision is effective for flights beginning after September 30, 1997.

6. Eliminate double taxation of certain aviation fuels sold to producers by "fixed base operators" (sec. 1236 of the bill and sec. 4091 of the Code)

Present Law

Section 4091 imposes a tax on the sale of aviation fuel by any producer (defined to include a wholesale distributor). Fuel sold at many rural airports is sold by retail dealers who do not qualify as wholesale distributors. This fuel is purchased by the retailers tax-paid. In certain instances, fuel which has been purchased tax-paid by a retailer will be re-sold to a producer, e.g., to enable the producer to serve one of its customers at the airport. When this fuel is resold at retail by the producer, a second tax is imposed. The Code contains no provision allowing a refund of the first tax in such cases.

Reasons for Change

Permitting a refund of the tax previously paid on aviation fuel when a producer resells the fuel and pays tax on the resale will improve the fairness of the tax collection for such fuel.

Explanation of Provision

The bill will permit a refund of the tax previously paid on aviation fuel when a producer acquires the fuel, resells it, and pays tax on the second sale.

Effective Date

The provision is effective for fuel sold after September 30, 1997.

D. Tax-Exempt Bond Provisions

Overview

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (Code sec. 103).

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (1) a private business use and payment test or (2) a private loan restriction. However, interest on private activity bonds is not taxable if (1) the financed activity is specified in the Code and (2) at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private activity bonds) for the interest on these bonds to be excluded from gross income.

1. Repeal of $100,000 limitation on unspent proceeds under 1-year exception from rebate (sec. 1241 of the bill and sec. 148 of Code)

Present Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance.

This six-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of five percent or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Reasons for Change

Exemption of interest paid on State and local bonds from Federal income tax provides an implicit subsidy to State and local governments for their borrowing costs. The principal Federal policy concern underlying the arbitrage rebate requirement is to discourage the earlier and larger than necessary issuance of tax-exempt bonds to take advantage of the opportunity to profit by investing funds borrowed at low-cost tax-exempt rates in higher yielding taxable investments. If at least 95 percent of the proceeds of an issue is spent within six months, and the remainder is spent within one year, opportunities for such arbitrage profit are significantly limited.

Explanation of Provision

The $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement is deleted. Thus, if at least 95 percent of the proceeds of these bonds is spent within six months after their issuance, and the remainder is spent within one year, the six-month exception is deemed to be satisfied.

Effective Date

The provision applies to bonds issued after the date of enactment.

2. Exception from rebate for earnings on bona fide debt service fund under construction bond rules (sec. 1242 of the bill and sec. 148 of the Code)

Present Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally-owned property.

This exception is satisfied only if the available construction proceeds of the issue are spent at minimum specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund, a bona fide debt service fund, or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating arbitrage profits if they fail to satisfy the exception's spending requirements.

Reasons for Change

Bond proceeds invested in a bona fide debt service fund generally must be spent at least annually for current debt service. The short-term nature of investments in such funds results in only limited potential for generating arbitrage profits. If the spending requirements of the 24-month rebate exception are satisfied, the administrative complexity of calculating rebate on these proceeds outweighs the other Federal policy concerns addressed by the rebate requirement.

Explanation of Provision

The bill exempts earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the penalty requirement of the 24-month exception if the spending requirements of that exception are otherwise satisfied.

Effective Date

The provision applies to bonds issued after the date of enactment.

3. Repeal of debt service-based limitation on investment in certain nonpurpose investments (sec. 1243 of the bill and sec. 148 of the Code)

Present Law

Issuers of all tax-exempt bonds generally are subject to two sets of restrictions on investment of their bond proceeds to limit arbitrage profits. The first set requires that tax-exempt bond proceeds be invested at a yield that is not materially higher (generally defined as 0.125 percentage points) than the bond yield ("yield restrictions"). Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds and, throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a "minor" portion of the issue proceeds.

Except for temporary periods and amounts held pending use to pay current debt service, present law also limits the amount of the proceeds of private activity bonds (other than qualified 501(c)(3) bonds) that may be invested at materially higher yields at any time during a bond year to 150 percent of the debt service for that bond year. This restriction affects primarily investments in reasonably required reserve or replacement funds. Present law further restricts the amount of proceeds from the sale of bonds that may be invested in these reserve funds to ten percent of such proceeds.

The second set of restrictions requires generally that all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing be rebated to the Federal Government ("arbitrage rebate"). Arbitrage profits include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Reasons for Change

The 150-percent of debt service limit was enacted before enactment of the arbitrage rebate requirement and the ten-percent limit on the size of reasonably required reserve or replacement funds. It was intended to eliminate arbitrage-motivated activities available from investment of such reserve funds. Provided that comprehensive yield restriction and arbitrage rebate requirements and the present-law overall size limit on reserve funds are maintained, the 150-percent of debt service yield restriction limit is duplicative.

Explanation of Provision

The bill repeals the 150-percent of debt service yield restriction.

Effective Date

The provision applies to bonds issued after the date of enactment.

4. Repeal of expired provisions relating to student loan bonds (sec. 1244 of the bill and sec. 148 of the Code)

Present Law

Present law includes two special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. These exceptions applied only to bonds issued before January 1, 1989.

Explanation of Provision

These special exceptions are deleted as "deadwood."

Effective Date

The provision applies to bonds issued after the date of enactment. It has no effect on bonds issued prior to the date of enactment.

E. Tax Court Procedures

1. Overpayment determinations of Tax Court (sec. 1251 of the bill and sec. 6512 of the Code)

Present Law

The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Court's decision becomes final. Whether such an order is appealable is uncertain.

In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Reasons for Change

Clarification of the jurisdiction of the Tax Court and the ability to appeal orders of the Tax Court would provide for greater certainty for taxpayers and the government in conducting cases before the Tax Court. Clarification will also reduce litigation.

Explanation of Provision

The bill clarifies that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The bill also clarifies that the Tax Court does not have jurisdiction over the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Effective Date

The provision is effective on the date of enactment.

2. Redetermination of interest pursuant to motion (sec. 1252 of the bill and sec. 7481 of the Code)

Present Law

A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court.

Reasons for Change

It would be beneficial to taxpayers if a proceeding for a redetermination of interest supplemented the original deficiency action brought by the taxpayer to redetermine the deficiency determination of the IRS. A motion, rather than a petition, is a more appropriate pleading for relief in these cases.

Explanation of Provision

The bill provides that a taxpayer must file a "motion" (rather than a "petition") to seek a redetermination of interest in the Tax Court.

Effective Date

The provision is effective on the date of enactment.

3. Application of net worth requirement for awards of litigation costs (sec. 1253 of the bill and sec. 7430 of the Code)

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

Reasons for Change

Although the net worth requirements are explicit for individuals, corporations, and partnerships, it is not clear which net worth requirement is to apply to other potential litigants. It is also unclear how the individual net worth rules are to apply to individuals filing a joint tax return. Clarifying these rules will provide certainty for potential claimants and will decrease needless litigation over procedural issues.

Explanation of Provision

The bill provides that the net worth limitations currently applicable to individuals also apply to estates and trusts. The bill also provides that individuals who file a joint tax return shall be treated as separate individuals for purposes of computing the net worth limitations.

Effective Date

The provision applies to proceedings commenced after the date of enactment.

4. Tax Court jurisdiction for determination of employment status (sec. 1254 of the bill and new sec. 7435 of the Code)

Present Law

The Tax Court is a court of limited jurisdiction, established under Article I of the Constitution. The Tax Court only has the jurisdiction that is expressly conferred on it by statute (sec. 7442).

Reasons for Change

It will be advantageous to taxpayers to have the option of going to the Tax Court to resolve certain disputes regarding employment status.

Explanation of Provision

The bill provides that, in connection with the audit of any person, if there is an actual controversy involving a determination by the IRS as part of an examination that (a) one or more individuals performing services for that person are employees of that person or (b) that person is not entitled to relief under section 530 of the Revenue Act of 1978, the Tax Court would have jurisdiction to determine whether the IRS is correct. For example, one way the IRS could make the required determination is through a mechanism similar to the employment tax early referral procedures.[146] A failure to agree would also be considered a determination for this purpose.

The bill provides for de novo review (rather than review of the administrative record). Assessment and collection of the tax would be suspended while the matter is pending in the Tax Court. Any determination by the Tax Court would have the force and effect of a decision of the Tax Court and would be reviewable as such; accordingly, it would be binding on the parties. Awards of costs and certain fees (pursuant to section 7430) would be available to eligi-

[146] See Announcement 96–13 and Announcement 97–52.

ble taxpayers with respect to Tax Court determinations pursuant to this proposal. The bill also provides a number of procedural rules to incorporate this new jurisdiction within the existing procedures applicable in the Tax Court.

Effective Date

The provision takes effect on the date of enactment.

F. Other Provisions

1. Due date for first quarter estimated tax payments by private foundations (sec. 1261 of the bill and sec. 6655(g)(3) of the Code)

Present Law

Under section 4940, tax-exempt private foundations generally are required to pay an excise tax equal to two percent of their net investment income for the taxable year. Under section 6655(g)(3), private foundations are required to pay estimated tax with respect to their excise tax liability under section 4940 (as well as any unrelated business income tax (UBIT) liability under section 511).[147] Section 6655(c) provides that this estimated tax is payable in quarterly installments and that, for calendar-year foundations, the first quarterly installment is due on April 15th. Under section 6655(I), foundations with taxable years other than the calendar year must make their quarterly estimated tax payments no later than the dates in their fiscal years that correspond to the dates applicable to calendar-year foundations.

Reasons for Change

Because a private foundation's estimated tax payments are determined, in part, by reference to the foundation's tax liability for the preceding year, the due date of a foundation's first-quarter estimated tax payment should be the same date for filing the foundation's annual return (Form 990–PF) for the preceding year.

Explanation of Provision

The bill amends section 6655(g)(3) to provide that a calendar-year foundation's first-quarter estimated tax payment is due on May 15th (which is the same day that its annual return, Form 990-PF, for the preceding year is due). As a result of the operation of present-law section 6655(I), fiscal-year foundations would be required to make their first-quarter estimated tax payment no later than the 15th day of the fifth month of their taxable year.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

[147] Generally, the amount of the first quarter payment must be at least 25 percent of the lesser of (1) the preceding year's tax liability, as shown on the foundation's Form 990–PF, or (2) 95 percent of the foundation's current-year tax liability.

2. Withholding of Commonwealth income taxes from the wages of Federal employees (sec. 1262 of the bill and sec. 5517 of title 5, United States Code)

Present Law

If State law provides generally for the withholding of State income taxes from the wages of employees in a State, the Secretary of the Treasury shall (upon the request of the State) enter into an agreement with the State providing for the withholding of State income taxes from the wages of Federal employees in the State. For this purpose, a State is a State, territory, or possession of the United States. The Court of Appeals for the Federal Circuit recently held in *Romero* v. *United States* (38 F.3d 1204 (1994)) that Puerto Rico was not encompassed within this definition; consequently, the court invalidated an agreement between the Secretary of the Treasury and Puerto Rico that provided for the withholding of Puerto Rico income taxes from the wages of Federal employees.

Reasons for Change

The Committee believes that employees of the United States should be in no better or worse position than other employees vis-a-vis local withholding.

Explanation of Provision

The bill makes any Commonwealth eligible to enter into an agreement with the Secretary of the Treasury that would provide for income tax withholding from the wages of Federal employees.

Effective Date

The provision is effective January 1, 1998.

3. Certain notices disregarded under provision increasing interest rate on large corporate underpayments (sec. 1263 of the bill and sec. 6621 of the Code)

Present Law

The interest rate on a large corporate underpayment of tax is the Federal short-term rate plus five percentage points. A large corporate underpayment is any underpayment by a subchapter C corporation of any tax imposed for any taxable period, if the amount of such underpayment for such period exceeds $100,000. The large corporate underpayment rate generally applies to periods beginning 30 days after the earlier of the date on which the first letter of proposed deficiency, a statutory notice of deficiency, or a nondeficiency letter or notice of assessment or proposed assessment is sent. For this purpose, a letter or notice is disregarded if the taxpayer makes a payment equal to the amount shown on the letter or notice within that 30 day period.

Reasons for Change

The large corporate underpayment rate generally applies if the underpayment of tax for a taxable period exceeds $100,000, even if the initial letter or notice of deficiency, proposed deficiency, assessment, or proposed assessment is for an amount less than $100,000. Thus, for example, under present law, a nondeficiency notice relating to a relatively minor mathematical error by the taxpayer may result in the application of the large corporate underpayment rate to a subsequently identified income tax deficiency.

Explanation of Provision

For purposes of determining the period to which the large corporate underpayment rate applies, any letter or notice is disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (determined by not taking into account any interest, penalties, or additions to tax).

Effective Date

The provision is effective for purposes of determining interest for periods after December 31, 1997.

TITLE XIII. PENSION SIMPLIFICATION

1. Matching contributions of self-employed individuals not treated as elective deferrals (sec. 1301 of the bill and sec. 402(g) of the Code)

Present Law

A qualified cash or deferred arrangement (a "section 401(k) plan") is a type of tax-qualified pension plan under which employees can elect to make pre-tax contributions. An employee's annual elective contributions are subject to a dollar limit ($9,500 for 1997). Employers may make matching contributions based on employees' elective contributions. In the case of employers, such matching contributions are not subject to the $9,500 limit on elective contributions.

Under present law, matching contributions made for a self-employed individual are generally treated as additional elective contributions by the self-employed individual who receives the matching contribution. Accordingly, elective contributions and matching contributions for such self-employed individual are subject to the section 401(k) limits on elective contributions.

Reasons for Change

The Committee believes it is appropriate to treat self-employed individuals in the same manner as other employees with regard to the limitations on matching contributions.

Explanation of Provision

The bill provides that matching contributions for self-employed individuals are treated the same as matching contributions for employees, i.e., they are not treated as elective contributions and are not subject to the elective contribution limit.

Effective Date

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

2. Contributions to IRAs through payroll deductions (sec. 1302 of the bill)

Present Law

Under present law, employer involvement in the establishment or maintenance of individual retirement arrangements ("IRAs") of its employees can result in the employer being considered to maintain a retirement plan for purposes of title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), thus subjecting the employer to ERISA's fiduciary rules.

Reasons for Change

Some employers would like to assist their employees by providing payroll withholding for IRA contributions but are concerned that if they do so they will be subject to ERISA. The Committee would like to encourage employers to facilitate savings for their employees.

Explanation of Provision

The bill provides that an employer that facilitates IRA contributions by its employees by establishing a system under which employees, through employer payroll deductions, may make contributions to IRAs will not be considered to sponsor a retirement plan subject to ERISA. Under the system, employees would be required to provide their employer with a contribution certificate which establishes the IRA and specifies the contribution amount to be deducted from the employee's wages and remitted to the employee's IRA. As under present law, the amount contributed through payroll deduction would be includible in the employee's gross income and wages for employment tax purposes, and deductible by the employee in accordance with the rules relating to IRAs.

The provision does not apply to an employee employed by an employer who maintains a tax-qualified retirement plan.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

3. Plans not disqualified merely by accepting rollover contributions (sec. 1303 of the bill and sec. 401(a) of the Code)

Present Law

Under present law, a qualified retirement plan that accepts rollover contributions from other plans will not be disqualified because the plan making the distribution is, in fact, not qualified at the time of the distribution, if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was qualified. The receiving plan can reasonably conclude that the distributing plan was qualified if, for example, prior to accepting the rollover, the distributing plan provided a statement that the distributing plan had a favorable determination letter issued by the Internal Revenue Service ("IRS"). The receiving plan is not required to verify this information.

Reasons for Change

In order to encourage employers to accept rollovers from other qualified retirement plans, the Committee believes that the receiving plans should be insulated from disqualification based on the subsequent qualified status of the distributing plan.

Explanation of Provision

The bill clarifies the circumstances under which a qualified plan could accept rollover contributions without jeopardizing its qualified status. Under the provision, if the trustee of the plan making the distribution notifies the recipient plan that the distributing plan is intended to be a qualified plan, the plan receiving the rollover will not be disqualified if the distributing plan was not in fact a qualified plan.

Effective Date

The provision is effective for rollover contributions made after December 31, 1997.

4. Modification of prohibition on assignment or alienation (sec. 1304 of the bill, sec. 401(a)(13) of the Code)

Present Law

Under present law, amounts held in a qualified retirement plan for the benefit of a participant are not, except in very limited circumstances, assignable or available to personal creditors of the participant. A plan may permit a participant, at such time as benefits under the plan are in pay status, to make a voluntary revocable assignment of an amount not in excess of 10-percent of any benefit payment, provided the purpose is not to defray plan administration costs. In addition, a plan may comply with a qualified domestic relations order issued by a state court requiring benefit payments to former spouses or other "alternate payees" even if the participant is not in pay status.

There is no specific exception under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") or the Internal Revenue Code which would permit the offset of a participant's benefit against the amount owed to a plan by the participant as a result of a breach of fiduciary duty to the plan or criminality involving the plan. Courts have been divided in their interpretation of the prohibition on assignment or alienation in these cases. Some courts have ruled that there is no exception in ERISA for the offset of a participant's benefit to make a plan whole in the case of a fiduciary breach. Other courts have reached a different result and permitted an offset of a participant's benefit for breach of fiduciary duties.

Reasons for Change

The Committee believes that the assignment and alienation rules should be clarified by creating a limited exception that permits participants' benefits under a qualified plan to be reduced under certain circumstances including the participant's breach of fiduciary duty to the plan.

Explanation of Provision

The bill permits a participant's benefit in a qualified plan to be reduced to satisfy liabilities of the participant to the plan due to (1) the participant being convicted of committing a crime involving the plan, (2) a civil judgment (or consent order or decree) entered by a court in an action brought in connection with a violation of the fiduciary provisions of ERISA, or (3) a settlement agreement between the Secretary of Labor or the Pension Benefit Guaranty Corporation and the participant in connection with a violation of the fiduciary provisions of ERISA. The court order establishing such liability must require that the participant's benefit in the plan be applied to satisfy the liability. If the participant is married at the time his or her benefit under the plan is offset to satisfy the liability, spousal consent to such offset is required unless the spouse is also required to pay an amount to the plan in the judgment, order, decree or settlement or the judgment, order, decree or settlement provides a 50-percent survivor annuity for the spouse. The bill will make the corresponding changes to ERISA.

Effective Date

The provision is effective for judgments, orders, and degrees issued, and settlement agreements entered into, on or after the date of enactment.

5. Elimination of paperwork burdens on plans (sec. 1305 of the bill and sec. 101 of ERISA)

Present Law

Under present law, employers are required to prepare summary plan descriptions of employee benefit plans ("SPDs'), and summaries of material modifications to such plans ("SMMs'). The SPDs and SMMs generally provide information concerning the benefits provided by the plan and the participants' rights and obligations under the plan. The SPDs and SMMs must be furnished to plan participants and beneficiaries and filed with the Secretary of Labor.

Reasons for Change

The Committee believes it is appropriate to alleviate the cost and burden of paperwork associated with employee benefit plans.

Explanation of Provision

The bill eliminates the requirement that SPDs and SMMs be filed with the Secretary of Labor. Employers would be required to furnish these documents to the Secretary of Labor upon request. A civil penalty could be imposed by the Secretary of Labor on the plan administrator for failure to comply with such requests. The penalty would be up to $100 per day of failure, up to a maximum of $1,000 per request. No penalty would be imposed if the failure was due to matters reasonably outside the control of the plan administrator.

Effective Date

The provision is effective on the date of enactment.

6. Modification of section 403(b) exclusion allowance to conform to section 415 modifications (sec. 1306 of the bill and sec. 403(b) of the Code)

Present Law

Under present law, annual contributions to a section 403(b) annuity cannot exceed the exclusion allowance. In general, the exclusion allowance for a taxable year is the excess, if any, of (1) 20 percent of the employee's includible compensation multiplied by his or her years of service, over (2) the aggregate employer contributions for an annuity excludable for any prior taxable years. Includible compensation means the amount of compensation from the employer that is includible in gross income for the most recent year that can be counted as a year of service.

Alternatively, an employee may elect to have the exclusion allowance determined under the rules relating to tax-qualified defined contribution plans (sec. 415). Under those rules, the maximum annual addition that can be made to a defined contribution plan is the lesser of (1) $30,000 or 25 percent of compensation. For years beginning after December 31, 1996, compensation for this purpose includes certain elective deferrals of the employee. An overall limitation applies if the employee is a participant in both a defined contribution plan and a defined benefit plan of the same employer. This overall limitation may further reduce the maximum annual addition that could be made to a defined contribution plan. The overall limitation is repealed with respect to years beginning after December 31, 1999. Existing Treasury regulations relating to the alternative method of determining the exclusion allowance refer to the overall limit.

Reasons for Change

The exclusion allowance for tax-sheltered annuities should be modified to reflect recent changes to the corresponding limits on benefits under tax-qualified plans.

Explanation of Provision

The bill conforms the exclusion allowance to the way in which the section 415 limit is calculated by providing that includible compensation includes elective deferrals of the employee, and contributions made at the election of the employee to an unfunded deferred compensation plan of a tax-exempt or State or local government (a sec. 457 plan) or a cafeteria plan.

The bill directs the Secretary to revise the regulations regarding the exclusion allowance to reflect the fact that the overall limit on benefits and contributions is repealed. The revised regulations are to be effective for limitation years beginning after December 31, 1999.

Effective Date

The modification to the definition of includible compensation is effective for years beginning after December 31, 1997. The direction to the Secretary is effective on the date of enactment.

7. New technologies in retirement plans (sec. 1307 of the bill)

Present Law

Under present law it is not clear if sponsors of employee benefit plans may use new technologies (telephonic response systems, computers, email) to satisfy the various ERISA requirements for notice, election, consent, record keeping, and participant disclosure.

Reasons for Change

The Committee believes it is appropriate to review existing guidance for purposes of permitting the use of new technologies for notice and record keeping requirements for retirement plans.

Explanation of Provision

The bill directs the Secretaries of the Treasury and Labor to each issue guidance facilitating the use of new technology for plan purposes. The guidance will be designed to (1) interpret the notice, election, consent, disclosure, and time requirements (and related recordkeeping requirements) under the Internal Revenue Code of 1986 ("IRC") and the Employee Retirement Income Security Act of 1974, as amended ("ERISA") relating to retirement plans as applied to the use of new technologies by plan sponsors and administrators while maintaining the protection of the rights of participants and beneficiaries, and (2) clarify the extent to which writing requirements under the IRC shall be interpreted to permit paperless transactions.

Effective Date

The provision is effective on the date of enactment and requires that the guidance be issued not later than December 31, 1998.

8. Permanent moratorium on application of nondiscrimination rules to governmental plans (sec. 1308 of the bill and secs. 401 and 403(b) of the Code)

Present Law

Under present law, the rules applicable to governmental plans require that such plans satisfy certain nondiscrimination and minimum participation rules. In general, the rules require that a plan not discriminate in favor of highly compensated employees with regard to the contribution and benefits provided under the plan, participation in the plan, coverage under the plan, and compensation taken into account under the plan. The nondiscrimination rules apply to all governmental plans; qualified retirement plans (including cash or deferred arrangements (sec. 401(k) plans) in effect before May 6, 1986) and annuity plans (sec. 403(b) plans).

For purposes of satisfying the nondiscrimination rules, the Internal Revenue Service has issued several Notices which extended the effective date for compliance for governmental plans. Governmental plans will be required to comply with the nondiscrimination rules beginning with plan years beginning on or after the later of January 1, 1999, or 90 days after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously. For plan years beginning before the extended effective date, governmental plans are deemed to satisfy the nondiscrimination requirements.

Reasons for Change

The Committee believes that, because of the unique circumstances applicable to governmental plans and the complexity of compliance, the moratorium on compliance with the nondiscrimination rules should be made permanent.

Explanation of Provision

The bill provides that governmental plans are exempt from the nondiscrimination and minimum participation rules.

Effective Date

The provision is effective for taxable years beginning on and after the date of enactment.

9. Clarification of certain rules relating to employee stock ownership plans of S corporations (sec. 1309 of the bill and sec. 409 of the Code)

Present Law

Under present law, an S corporation can have no more than 75 shareholders. For taxable years beginning after December 31, 1997, certain tax-exempt organizations, including employee stock ownership plans ("ESOPs") can be a shareholder of an S corporation.

ESOPs are generally required to make distributions in the form of employer securities. If the employer securities are not readily tradable, the employee has a right to require the employer to buy the securities. In the case of an employer whose bylaws or charter restricts ownership of substantially all employer securities to employees or a pension plan, the plan may provide that benefits are distributed in the form of cash. Such a plan may distribute employer securities, if the employee has a right to require the employer to purchase the securities.

ESOPs are subject to certain prohibited transaction rules designed to prohibit certain transactions between the plan and certain persons close to the plan. A number of statutory exceptions are provided to the prohibited transaction rules, including exceptions for loans between the plan and plan participants and certain sales of stock to the ESOP. These statutory exceptions do not apply to shareholder-employees of S corporations. However, such individuals can obtain an administrative exception from such rules from the Department of Labor.

Reasons for Change

It is possible that an S corporation may lose its status as such if the ESOP is required to give stock to plan participants, rather than cash equal to the value of the stock. Changes to the prohibited transactions rules are appropriate to facilitate the maintenance of an ESOP by an S corporation.

Explanation of Provision

The bill provides that ESOPs of S corporations may distribute cash to plan participants as long as the employee has a right to require the employer to purchase the securities (as under the present-law rules). In addition, the bill extends the exception to certain prohibited transactions rules to S corporations.

Effective Date

The provision is effective for taxable years beginning after December 31, 1997.

10. Modification of 10-percent tax on nondeductible contributions (sec. 1310 of the bill and sec. 4972 of the Code)

Present Law

Under present law, contributions to qualified pension plans are deductible within certain limits. In the case of a single-employer defined benefit plan which has more than 100 participants during the year, the maximum amount deductible is not less than the plan's unfunded current liability as determined under the minimum funding rules. Limits are also imposed on the amount of annual deductible contributions if an employer sponsors both a defined benefit plan and a defined contribution plan that covers some of the same employees. Under the combined plan limitation, the total deduction for all plans for a plan year is generally limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit plan for the year.

A 10-percent nondeductible excise tax is imposed on contributions that are not deductible. This excise tax does not apply to contributions to one or more defined contribution plans that are nondeductible because they exceed the combined plan deduction limit to the extent such contributions do not exceed 6 percent of compensation in the year for which the contribution is made.

Reasons for Change

The Committee believes that present law unfairly penalizes employers by imposing an excise tax on employer plan contributions that are required to be made and that are not deductible because the employer is fully funding its pension plan. In particular, the Committee does not believe that the excise tax on nondeductible contributions should be imposed when an employer is required to make contributions attributable to elective deferrals under a section 401(k) plan and employer matching contributions.

Explanation of Provision

The bill adds an additional exception to the 10-percent excise tax on nondeductible contributions. Under the provision, the excise tax does not apply to contributions to one or more defined contribution plans that are not deductible because they exceed the combined plan deduction limit to the extent such contributions do not exceed the amount of the employer's matching contributions plus the elective deferral contributions to a section 401(k) plan.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1997.

11. Modify funding requirements for certain plans (sec. 1311 of the bill and sec. 412 of the Code)

Present Law

Under present law, defined benefit pension plans are required to meet certain minimum funding rules. Underfunded plans are required to satisfy certain faster funding requirements. In general, these additional requirements do not apply in the case of plans with a funded current liability percentage of at least 90 percent.

The Pension Benefit Guaranty Corporation ("PBGC") insures benefits under most defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and a variable rate premium based on plan underfunding.

Reasons for Change

Certain interstate bus companies have pension plans that are closed to new participants and the participants in these plans have demonstrated mortality significantly greater than that predicted by the mortality tables that the plans are required to use for minimum funding purposes. As a result, the sponsors of such plans are required to make contributions that cause the plan to be substantially overfunded. The Committee believes it appropriate to modify the minimum funding requirements for such plans, while at the same time ensuring that pension benefits are adequately funded.

Explanation of Provision

The bill modifies the minimum funding requirements in the case of certain plans. The bill applies in the case of plans that (1) were not required to pay a variable rate PBGC premium for the plan year beginning in 1996, (2) do not, in plan years beginning after 1995 and before 2009, merge with another plan (other than a plan sponsored by an employer that was a member of the controlled group of the employer in 1996), and (3) are sponsored by a company that is engaged primarily in the interurban or interstate passenger bus service.

The bill treats a plan to which it applies as having a funded current liability percentage of at least 90 percent for plan years beginning after 1996 and before 2005. For plan years beginning after 2004, the funded current liability percentage will be deemed to be at least 90 percent if the actual funded current liability percentage is at least as follows:

Plan year beginning in:	*Minimum percentage*
2005	86
2006	87
2007	88
2008	89
2009 and thereafter	90

If the funded current liability percentage falls below 85 percent for a plan year beginning before 2005, the rule described above still applies if contributions for any such year are made to the plan in an amount equal to the lesser of: (1) the amount necessary to bring the funded current liability percentage to 85 percent, or (2) the greater of (a) 2 percent of the plan's current liability as of the beginning of such plan year or (b) the amount necessary to bring the funded current liability percentage to 80 percent as of the end of such plan year.

The relief from the minimum funding requirements applies for the plan year beginning in 2005, 2006, 2007, and 2008 only if contributions to the plan equal at least the expected increase in current liability due to benefits accruing during the plan year.

Effective Date

The provision is effective with respect to contributions due after December 31, 1997.

TITLE XIV. TECHNICAL CORRECTION PROVISIONS

I. TECHNICAL CORRECTIONS TO THE SMALL BUSINESS JOB PROTECTION ACT OF 1996

A. Small Business-Related Provisions

1. Returns relating to purchases of fish (sec. 1401(a)(1) of the bill and sec. 6050R(c)(1) of the Code)

Present Law

Every person engaged in the trade or business of purchasing fish for resale must file an informational return reporting its purchases from any person that is engaged in the trade or business of catching fish which are in excess of $600 for any calendar year. Persons filing such an informational return relating to the purchase of fish must furnish a statement showing the name and address of the person filing the return, as well as the amount shown on the return, to each person whose name is required to be disclosed on the return.

Explanation of Provision

Every person filing an informational return relating to the purchase of fish must furnish a statement showing the phone number of the person filing the return, as well as such person's name, address and the amount shown on the return, to each person whose name is required to be disclosed on the return.

2. Charitable remainder trusts not eligible to be electing small business trusts (sec. 1402(c)(1) of the bill and sec. 1361(c)(1)(B) of the Code)

Present Law

Under present law, an electing small business trust may be a shareholder in an S corporation. In order to qualify for this treatment, all beneficiaries of the electing small business trust generally must be individuals or estates eligible to be S corporation shareholders. An exempt trust may not qualify as an electing small business trust.

Description of Provision

The provision clarifies that charitable remainder annuity trusts and charitable remainder unitrusts may not be electing small business trusts.

3. Clarify the effective date for post-termination transition period provision (sec. 1401(c)(2) of the bill)

Present Law

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

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

The Small Business Act expanded the post-termination period to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of "determination" was expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person. The Small Business Act provision was effective for taxable years beginning after December 31, 1996.

Explanation of Provision

The technical correction clarifies that the effective date for the Small Business Act provision affecting the post-termination transition period is for determinations after December 31, 1996, not for determinations with respect to taxable years beginning after December 31, 1996. However, in no event will the post-termination transition period expanded by the Small Business Act end before the end of the 120-day period beginning after the date of enactment of this Act.

4. Treatment of qualified subchapter S subsidiaries (sec. 1401(c)(3) of the bill and sec. 1361(b)(3) of the Code)

Present Law

Pursuant to a provision of the Small Business Act, an S corporation is allowed to own a qualified subchapter S subsidiary. The term "qualified subchapter S subsidiary" means a domestic corporation that (1) is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if 100 percent of the stock of the subsidiary were held by its S corporation parent and (2) which the parent elects to treat as a qualified subchapter S subsidiary. Under the election, for all purposes of the Code, the qualified subchapter S subsidiary is not treated as a separate corporation and all the assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

The legislative history of the provision provides that if an election is made to treat an existing corporation as a qualified subchapter S subsidiary, the subsidiary will be deemed to have liquidated under sections 332 and 337 immediately before the election is effective.

Explanation of Provision

The technical correction provides that the Secretary of the Treasury may provide, by regulations, instances where the separate corporate existence of a qualified subchapter S subsidiary may be taken into account for purposes of the Code. Thus, if an S corporation owns 100 percent of the stock of a bank (as defined in sec. 581) and elects to treat the bank as a qualified subchapter S subsidiary, it is expected that Treasury regulations would treat the bank as a separate legal entity for purposes of those Code provisions that apply specifically to banks (e.g., sec. 582).

Treasury regulations also may provide exceptions to the general rule that the qualified subchapter S subsidiary election is treated as a deemed section 332 liquidation of the subsidiary in appropriate cases. In addition, if the effect of a qualified subchapter S subsidiary election is to invalidate an election to join in the filing of a consolidated return for a group of subsidiaries that formerly joined in such filing, Treasury regulations may provide guidance as to the consolidated return effects of the S election.

B. Pension Provisions

1. Salary reduction simplified employee pensions ("SARSEPS") (sec. 1401(d)(1)(B) of the bill and sec. 408(k)(6) of the Code)

Present Law

SARSEPs were repealed for years beginning after December 31, 1996, unless the SARSEP was established before January 1, 1997. Consequently, an employer was not permitted to establish a SARSEP after December 31, 1996. SARSEPs established before January 1, 1997, may continue to receive contributions under the rules in effect prior to January 1, 1997.

Explanation of Provision

The bill amends Code section 408(k)(6) to clarify that new employees of an employer hired after December 31, 1996, may participate in a SARSEP of an employer established before January 1, 1997.

2. SIMPLE retirement plans (secs. 1401(d)(1)(A) and (d)(1)(C)–(F) and 1401(d)(2) of the bill)

a. Reporting requirements for SIMPLE IRAs (sec. 1401(d)(1)(A) of the bill and sec. 408(i) of the Code)

Present Law

A trustee of an individual retirement account and the issuer of an individual retirement annuity must furnish reports regarding the account or annuity to the individual for whom the account or annuity is maintained not later than January 31 of the calendar year following the year to which the reports relate. In the case of a SIMPLE IRA, such reports are to be furnished within 30 days after each calendar year.

Explanation of Provision

The bill conforms the time for providing reports for SIMPLE IRAs to that for IRA reports generally. Thus, the bill would provide that the report required to be furnished to the individual under a SIMPLE IRA would be provided within 31 days after each calendar year.

b. Notification requirement for SIMPLE IRAs (sec. 1401(d)(1)(C) of the bill and secs. 408(l)(2) and 6693(c) of the Code)

Present Law

The trustee of any SIMPLE IRA is required to provide the employer maintaining the arrangement a summary plan description containing basic information about the plan. At least once a year, the trustee is also required to furnish an account statement to each individual maintaining a SIMPLE account. In addition, the trustee is required to file an annual report with the Secretary. A trustee who fails to provide any of such reports or descriptions will be subject to a penalty of $50 per day until such failure is corrected, unless the failure is due to reasonable cause.

Explanation of Provision

The bill provides that issuers of annuities for SIMPLE IRAs have the same reporting requirements as SIMPLE IRA trustees.

c. Maximum dollar limitation for SIMPLE IRAs (sec. 1401(d)(1)(D) of the bill and sec. 408(p) of the Code)

Present Law

The Small Business Act created a simplified retirement plan for small business called the savings incentive match plan for employees ("SIMPLE") retirement plan. A SIMPLE plan can be either an individual retirement arrangement ("IRA") for each employee or part of a qualified cash or deferred arrangement ("a 401(k) plan"). A SIMPLE IRA permits employees to make elective contributions up to $6,000 per year to their IRA. The employer is required to satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation, unless the employer elects a lower percentage matching contribution (but not less than 1 percent of each employee's compensation). Alternatively, an employer is permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee. The employer contribution amounts are contributed to the employee's IRA. The maximum contribution limitation to an IRA is $2,000.

Explanation of Provision

The bill provides that in the case of a SIMPLE IRA, the $2,000 maximum limitation applicable to IRAs is increased to the limitations in effect for contributions made under a qualified salary reduction arrangement. This includes employee elective contributions and required employer contributions.

d. Application of exclusive plan requirement for SIMPLE IRAs to noncollectively bargained employees (sec. 1401(d)(1)(E) of the bill and sec. 408(p)(2)(D) of the Code)

Present Law

A SIMPLE IRA will be treated as a qualified salary reduction arrangement provided the employer does not maintain a qualified plan during the same time period the SIMPLE IRA is maintained. Collectively bargained employees can be excluded from participation in the SIMPLE IRA and may be covered under a plan established by the employer as a result of a good faith bargaining agreement.

Explanation of Provision

The bill provides that an employer who maintains a plan for collectively bargained employees is permitted to maintain a SIMPLE IRA for noncollectively bargained employees.

e. Application of exclusive plan requirement for SIMPLE IRAs in the case of mergers and acquisitions (sec. 1401(d)(1)(F) of the bill and sec. 408(p)(2) of the Code)

Present Law

Only employers who employ 100 or fewer employees who received compensation for the preceding year of at least $5,000 are eligible to establish a SIMPLE IRA. An eligible employer maintaining a SIMPLE IRA who fails to be an eligible employer due to an acquisition, disposition or similar transaction is treated as an eligible employer for the 2 years following the last year the employer was eligible provided rules similar to the special coverage rules of section 410(b)(6)(C)(i) apply. There is no parallel provision with respect to an employer who, because of an acquisition, disposition or similar transaction, maintains a qualified plan and a SIMPLE IRA at the same time.

Explanation of Provision

The bill provides that if an employer maintains a qualified plan and a SIMPLE IRA in the same year due to an acquisition, disposition or similar transaction the SIMPLE IRA is treated as a qualified salary reduction arrangement for the year of the transaction and the following calendar year.

f. Top-heavy exemption for SIMPLE 401(k) arrangements (sec. 1401(d)(2)(A) of the bill and sec. 401(k)(11)(D) of the Code)

Present Law

A plan meeting the SIMPLE 401(k) requirements for any year is not treated as a top-heavy plan under section 416 for the year. This rule was intended to apply only to SIMPLE 401(k)s, and not other plans maintained by the employer.

Explanation of Provision

The bill provides that the top-heavy exemption applies to a plan which permits only contributions required to satisfy the SIMPLE 401(k) requirements.

g. Cost of living adjustments for SIMPLE 401(k) arrangements (sec. 1401(d)(2)(B) of the bill and sec. 401(k)(11) of the Code)

Present Law

The $6,000 limit on deferrals to a SIMPLE IRA is subject to a cost-of-living adjustment. There is no parallel provision applicable to a SIMPLE 401(k) arrangement.

Explanation of Provision

The bill provides that the $6,000 limit on elective deferrals under a SIMPLE 401(k) arrangement will be adjusted at the same time and in the same manner as for SIMPLE IRAs.

h. Employer deduction for SIMPLE 401(k) arrangements (sec. 1401(d)(2)(C) of the bill and sec. 404(a)(3) of the Code)

Present Law

Contributions paid by an employer to a profit sharing or stock bonus plan are deductible by the employer for a taxable year to the extent the contributions do not exceed 15-percent of the compensation otherwise paid or accrued during the taxable year to the participants under the plan. Contributions paid by an employer to a profit sharing or stock bonus plan that are not deductible because they are in excess of the 15-percent limitation are subject to a 10-percent excise tax payable by the employer making the contribution.

Explanation of Provision

The bill provides that to the extent that contributions paid by an employer to a SIMPLE 401(k) arrangement satisfy the contribution requirements of section 401(k)(11)(B), such contributions is deductible by the employer for the taxable year.

i. Notification and election periods for SIMPLE 401(k) arrangements (sec. 1401(d)(2)(D) of the bill and sec. 401(k)(11) of the Code)

Present Law

An employer maintaining a SIMPLE 401(k) arrangement is required to make a matching contribution for employees making elective deferrals of up to 3-percent of compensation (or, alternatively, elect to make a 2-percent of compensation nonelective contribution on behalf of all eligible employees). An employer electing to make a 2-percent nonelective contribution is required to notify all employees of such election within a reasonable period of time before the 60th day before the beginning of the year.

An employer maintaining a SIMPLE IRA is required to notify each employee of the employee's opportunity to make or modify salary reduction contributions as well as the contribution alternative chosen by the employer within a reasonable period of time before the employee's election period. The employee's election period is the 60-day period before the beginning of any year (and the 60-day period before the first day such employee is eligible to participate).

Explanation of Provision

The bill extends the employer notice and employee election requirements of SIMPLE IRAs to SIMPLE 401(k) arrangements.

Effective Date

The bill is effective with respect to calendar years beginning after the date of enactment.

j. Treatment of Indian tribal governments under section 403(b) (sec. 1401(d)(5) of the bill and sec. 403(b) of the Code)

Present Law

Any 403(b) annuity contract purchased in a plan year beginning before January 1, 1995, by an Indian tribal government is treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. Such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government in accordance with the rollover rules of section 403(b)(8).

Explanation of Provision

The bill clarifies that an employee participating in a 403(b) annuity contract of the Indian tribal government would be permitted to roll over amounts from such contract to a section 401(k) plan maintained by the Indian tribal government whether or not the annuity contract is terminated.

C. Foreign Provisions

1. Measurement of earnings of controlled foreign corporations (sec. 1401(e) of the bill, subtitle E of the Act, and section 956 of the Code)

Present Law

U.S. 10-percent shareholders of a controlled foreign corporation (CFC) are subject to current U.S. tax on their pro rata shares of the CFC's earnings invested in United States property. For this purpose, earnings include both current earnings and profits (not including a deficit) referred to in section 316(a)(1) and accumulated earnings and profits referred to in section 316(a)(2). It could be argued that this definition of earnings takes current year earnings into account twice.

Explanation of Provision

The technical correction clarifies that accumulated earnings and profits of a CFC taken into account for purposes of determining the CFC's earnings invested in United States property do not include current earnings (which are taken into account separately). A similar technical correction to the definition of earnings for purposes of prior-law section 956A (relating to a CFC's earnings invested in excess passive assets) was enacted with the Small Business Job Protection Act of 1996 (section 1703(i)(2)).

2. Transfers to foreign trusts at fair market value (sec. 1401(i)(2) of the bill, sec. 1903 of the Act, and sec. 679 of the Code)

Present Law

A U.S. person who transfers property to a foreign trust which has U.S. beneficiaries generally is treated as the owner of such trust. However, this rule does not apply where the U.S. person transfers property to a trust in exchange for fair market value consideration. In determining whether the U.S. person receives fair market value consideration, obligations of certain related persons are not taken into account. For this purpose, related persons include the trust, any grantor or beneficiary of the trust, and certain persons who are related to any such grantor or beneficiary.

Explanation of Provision

The technical correction clarifies that, for purposes of determining whether a U.S. person's transfer to a trust is for fair market value consideration, the related persons whose obligations are disregarded include any owner of the trust and certain persons who are related to any such owner.

3. Treatment of trust as U.S. person (sec. 1401(i)(3) of the bill, sec. 1907 of the Act, and secs. 641 and 7701(a)(30) of the Code)

Present Law

A trust is considered to be a U.S. person if two criteria are met. First, a court within the United States must be able to exercise primary supervision over the administration of the trust. Second, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the trust.

These criteria regarding the treatment of a trust as a U.S. person are effective for taxable years beginning after December 31, 1996. The Internal Revenue Service announced procedures under which a U.S. trust in existence on August 20, 1996 may continue to file returns as a U.S. trust for taxable years beginning after December 31, 1996. To qualify for such treatment, the trustee (1) must initiate modification of the trust to conform to the new criteria by the due date for filing the trust's return for its first taxable year beginning after 1996, (2) must complete the modification within two years of such date, and (3) must attach the required statement to the trust returns for the taxable years beginning after 1996.[148]

Explanation of Provision

The technical correction clarifies that a trust is treated as a U.S. person as long as one or more U.S. *persons* have the authority to control all substantial decisions of the trust (and a U.S. court can exercise primary supervision). Accordingly, the fact that a substantial decision of the trust is controlled by a U.S. person who is not a fiduciary would not cause the trust not to be treated as a U.S. person. In addition, the technical correction clarifies that a trust that is a foreign trust under these criteria is not considered to be present or resident in the United States at any time. Finally, the technical correction provides the Secretary of Treasury with authority to allow reasonable time for U.S. trusts in existence on August 20, 1996 to make modifications in order to comply with the new criteria for treatment of a trust as a U.S. person.

E. Other Provisions

1. Treatment of certain reserves of thrift institutions (sec. 1401(f)(5) of the bill and secs. 593(e) and 1374 of the Code)

Present Law

A provision of the Small Business Act repealed the percentage-of-taxable-income method for deducting bad debts applicable to thrift institutions. The portion of the section 481(a) adjustment applicable to pre-1988 reserves of an institution required to change its method of accounting generally is not restored to income unless the institution makes a distribution to which section 593(e) applies.

[148] Notice 96–65, I.R.B. 1996–52. See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS–12–96), December 12, 1996, pp. 277–278.

Section 593(e) provides that if an institution makes a nonliquidating distribution in an amount in excess of its post-1951 accumulated earnings and profits, such excess will be treated as a distribution of the post-1987 reserve for bad debts, requiring recapture of such amount.

Another provision of the Small Business Act allows a bank or a thrift institution to elect to be treated as an S corporation so long as the entity does not use a reserve method of accounting for bad debts. The earnings of an S corporation increase the corporation's accumulated adjustments account, but do not increase its accumulated earnings and profits (sec. 1368). In addition, any net unrealized built-in gains of a C corporation that converts to S corporation status that are recognized during the 10-year period beginning with the date of such conversion generally are subject to corporate-level tax (sec. 1374). Section 481(a) adjustments taken into account during the 10-year period generally are subject to section 1374.

Explanation of Provision

The bill provides rules to clarify the section 593(e) treatment of pre-1988 bad debt reserves of thrift and former thrift institutions that become S corporations. The technical corrections provide that (1) the accumulated adjustments account of an S corporation would be treated the same as post-1951 earnings and profits for purposes of section 593(e) and (2) section 593(e) would apply irrespective of section 1374 (e.g., distributions that trigger section 593(e) would be subject to corporate-level recapture even if such distributions occur after the 10-year period of section 1374).

2. "FASIT" technical corrections (sec. 1401(f)(6) of the bill and sec. 860L of the Code)

Present Law

In general

A "financial asset securitization investment trust" ("FASIT") is designed to facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally is not taxable; the FASIT's taxable income or net loss flows through to the owner of the FASIT.

The ownership interest of a FASIT generally is required to be entirely held by a single domestic C corporation. In addition, a FASIT generally must hold only qualified debt obligations, and certain other specified assets, and is subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue instruments (called "regular interests") that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. In general, those requirements must be met "after the startup date." Instruments bearing yields to maturity over 5 percentage points above the yield to maturity on specified United States Government obligations (i.e., "high-yield interests") may be held only by domestic C corporations that are not exempt from income tax.

Income from prohibited transactions

The owner of a FASIT is required to pay a penalty excise tax equal to 100 percent of net income derived from (1) an asset that is not a permitted asset, (2) any disposition of an asset other than a permitted disposition, (3) any income attributable to loans originated by the FASIT, and (4) compensation for services (other than fees for a waiver, amendment, or consent under permitted assets not acquired through foreclosure). A permitted disposition is any disposition of any permitted asset (1) arising from complete liquidation of a class of regular interests (i.e., a qualified liquidation)[149]; (2) incident to the foreclosure, default, or imminent default of the asset; (3) incident to the bankruptcy or insolvency of the FASIT; (4) necessary to avoid a default on any indebtedness of the FASIT attributable to a default (or imminent default) on an asset of the FASIT; (5) to facilitate a clean-up call; (6) to substitute a permitted debt instrument for another such instrument; or (7) in order to reduce over-collateralization where a principal purpose of the disposition was not to avoid recognition of gain arising from an increase in its market value after its acquisition by the FASIT.

Definition of "FASIT"

For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following "permitted assets": (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; (6) a regular interest in another FASIT; and (7) a regular interest in a REMIC. A FASIT must meet the asset test at the 90th day after its formation and at all times thereafter. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

Explanation of Provision

Definition of regular interest

The bill provides that the requirement of a "regular interest" must be met "on or after the startup date," instead of just "after the startup date."

Correction of cross reference

The bill corrects an incorrect cross reference in section 860L(d) from section 860L(c)(2) to section 860L(b)(2).

Tax on prohibited transactions

The bill provides that the tax on prohibited transactions would not apply to dispositions of foreclosure property or hedges using the similar exception applicable to REMICs.

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[149] For this purpose, a "qualified liquidation" has the same meaning as it does for purposes of the exemption from the tax on prohibited transactions of a real estate mortgage investment conduit ("REMIC") in section 860F(a)(4).

3. Qualified State tuition plans (sec. 1401(h)(1) of the bill and sec. 529 of the Code)

Present Law

Section 529 provides tax-exempt status to certain qualified State tuition programs and provides rules governing the tax treatment of distributions from such programs. Section 529 was effective on the date of enactment of the Small Business Job Protection Act of 1996, but a special transition rule provides that if (1) a State maintains (on the date of enactment) a program under which persons may purchase tuition credits on behalf of, or make contributions for educational expenses of, a designated beneficiary, and (2) such program meets the requirements of a qualified State tuition program before the later of (a) one year after the date of enactment, or (b) the first day of the first calendar quarter after the close of the first regular session of the State legislature that begins after the date of enactment, then the provisions of the Small Business Act will apply to contributions (and earnings allocable thereto) made before the date the program meets the requirements of a qualified State tuition program, without regard to whether the requirements of a qualified State tuition program are satisfied with respect to such contributions and earnings (e.g., even if the interest in the tuition or educational savings program covers not only qualified higher education expenses but also room and board expenses).

Explanation of Provision

The provision clarifies that, if a State program under which persons may purchase tuition credits comes into compliance with the requirements of a "qualified State tuition program" as defined in section 529 within a specified time period, then such program will be treated as a qualified State tuition program with respect to any contributions (and earnings allocable thereto) made pursuant to a contract entered into under the program before the date on which the program comes into compliance with the present-law requirements of a qualified State tuition program under section 529.

4. Adoption credit (sec. 1401(h)(2) of the bill, sec. 1807 of the Small Business Act, and sec. 23 of the Code)

Present Law

Taxpayers are allowed a maximum nonrefundable tax credit against income tax liability of $5,000 per child for qualified adoption expenses ($6,000 in the case of certain domestic adoptions) paid or incurred by the taxpayer. Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are directly related to the legal adoption of an eligible child.

Otherwise qualified adoption expenses paid or incurred in one taxable year are not taken into account for purposes of the credit until the next taxable year unless the expenses are paid or incurred in the year the adoption becomes final.

Explanation of Provision

The technical correction conforms the treatment of otherwise qualified adoption expenses paid or incurred in years after the year the adoption becomes final to the treatment of expenses paid or incurred in the year the adoption becomes final. Another technical correction repeals as "deadwood" an ordering rule inadvertently included in the credit.

5. Phaseout of adoption assistance exclusion (sec. 1401(h)(2) of the bill, sec. 1807 of the Small Business Act, and sec. 137 of the Code)

Present Law

The adoption tax credit and the exclusion for employer provided adoption assistance are generally phased out ratably for taxpayers with modified adjusted gross income (AGI) above $75,000, and are fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands, and residents of Puerto Rico, respectively).

Explanation of Provision

The technical correction conforms the phaseout range of the adoption assistance exclusion to the phaseout range of the credit for qualified adoption expenses.

II. HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996

1. Medical savings accounts (sec. 1402(a) of the bill and sec. 220 of the Code)

a. Additional tax on distributions not used for medical purposes

Present Law

Under present law, distributions from a medical savings account ("MSA") that are not used for medical expenses are includible in gross income and subject to a 15-percent additional tax unless the distribution is after age 65 or death or on account of disability. A similar additional 10-percent tax is imposed on early withdrawals from individual retirement arrangements and qualified pension plans. The 10-percent additional tax on early withdrawals is not treated as tax liability for purposes of the minimum tax. No such rule applies to the 15-percent additional tax applicable to MSAs.

Explanation of Provision

The bill provides that the 15-percent tax on nonmedical withdrawals from an MSA is not treated as tax liability for purposes of the minimum tax.

b. Definition of permitted coverage

Present Law

Under present law, in order to be eligible to have an MSA an individual must be covered under a high deductible health plan and no other health plan, except for plans that provide certain permitted coverage. Medicare supplemental plans are one of the types of permitted coverage, even though an individual covered by Medicare is not eligible to have an MSA.

Explanation of Provision

Under the bill, Medicare supplemental plans would be deleted from the types of permitted coverage an individual may have and still qualify for an MSA.

c. Taxation of distributions

Present Law

Under present law, in order to be eligible to have a medical savings account ("MSA") an individual must be covered under a high deductible health plan and no other health plan, except for plans that provide certain permitted coverage and must be either (1) a self-employed individual, or (2) employed by a small employer. Distributions from an MSA for the medical expenses of the MSA account holder and his or her spouse or dependents are generally excludable from income. However, in any year for which a contribution is made to an MSA, withdrawals from the MSA are excludable from income only if the individual for whom the expenses were incurred was an eligible individual for the month in which the expenses were incurred. This rule is designed to ensure that MSAs are used in conjunction with a high deductible plan and that they are not primarily used by other individuals who have health plans that are not high deductible plans.

Explanation of Provision

The bill would clarify that, in any year for which a contribution is made to an MSA, withdrawals from the MSA are excludable from income only if the individual for whom the expenses were incurred was covered under a high deductible health plan (and no other health plan except for plans that provide certain permitted coverage) in the month in which the expenses were incurred. That is, the individual for whom the expenses were incurred does not have to be self employed or employed by a small employer in order for a withdrawal for medical expenses to be excludible.

d. Penalty for failure to provide required reports

Present Law

Trustees of an MSA are required to provide such reports to the Secretary and the account holder as the Secretary may require. A penalty of $50 applies with respect to each failure to provide a required report. Under present law, separate penalties apply to information returns required by the Code.

Explanation of Provision

The bill provides that the $50 penalty does not apply to information returns.

2. Definition of chronically ill individual under a qualified long-term care insurance contract (sec. 1402(b) of the bill and sec. 7702B(c)(2) of the Code)

Present Law

Under the long-term care insurance rules, a chronically ill individual is one who has been certified within the previous 12 months by a licensed health care practitioner as (1) being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days due to a loss of functional capacity, (2) having a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described above, or (3) requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. A contract is not treated as a qualified long-term care insurance contract unless the determination of whether an individual is a chronically ill individual takes into account at least 5 of such activities.

Explanation of Provision

The technical correction clarifies that the five-activity requirement—i.e., that the number of activities of daily living that are taken into account not be less than five—applies only for purposes of the first of three alternative definitions of a chronically ill individual (Code sec. 7702B(c)(2)(A)(i)), that is, by reason of the individual being unable to perform (without substantial assistance) at least 2 activities of daily living for at least 90 days due to a loss of functional capacity. Thus, the requirement does not apply to the determination of whether an individual is a chronically ill individual either (1) by virtue of severe cognitive impairment, or (2) if the insured satisfies a standard (if any) that is not based upon activities of daily living, as determined under regulations.

3. Deduction for long-term care insurance of self-employed individuals (sec. 1402(c) of the bill and sec. 162(l)(2) of the Code)

Present Law

Present law provides that the deduction for health insurance expenses of a self-employed individual is not available for a month for which the individual is eligible to participate in any subsidized health plan maintained by any employer of the individual or the individual's spouse. Present law also provides that in the case of a qualified long-term care insurance contract, only eligible long-term care premiums (as defined for purposes of the medical expense deduction) are taken into account in determining the deduction for health insurance expenses of a self-employed individual.

Explanation of Provision

The technical correction applies the rules for the deduction for health insurance expenses of a self-employed individual separately with respect to (1) plans that include coverage for qualified long-term care services or that are qualified long-term care insurance contracts, and (2) plans that do not include such coverage and are not such contracts. Thus, the provision clarifies that the fact that an individual is eligible for employer-subsidized health insurance does not affect the ability of such an individual to deduct long-term care insurance premiums, so long as the individual is not eligible for employer-subsidized long-term care insurance.

4. Applicability of reporting requirements of long-term care contracts and accelerated death benefits (sec. 1402(d) of the bill and sec. 6050Q of the Code)

Present Law

Present law provides that amounts (other than policyholder dividends or premium refunds) received under a long-term care insurance contract generally are excludable as amounts received for personal injuries and sickness, subject to a dollar cap on per diem contracts only. If the aggregate amount of periodic payments under all qualified long-term care contracts exceeds the dollar cap for the period, then the amount of such excess payments is excludable only to the extent of the individual's costs (that are not otherwise compensated for by insurance or otherwise) for long-term care services during the period.

Present law also provides an exclusion from gross income as an amount paid by reason of the death of an insured for (1) amounts received under a life insurance contract and (2) amounts received for the sale or assignment of any portion of the death benefit under a life insurance contract to a qualified viatical settlement provider, provided that the insured under the life insurance contract is either terminally ill or chronically ill (the accelerated death benefit rules).

A payor of long-term care benefits (defined for this purpose to include any amount paid under a product advertised, marketed or offered as long-term care insurance), and a payor of amounts treated as subject to reporting under the accelerated death benefit rules, is required to report to the IRS the aggregate amount of such benefits paid to any individual during any calendar year, and the name, address and taxpayer identification number of such individual. A payor is also required to report the name, address, and taxpayer identification number of the chronically ill individual on account of whose condition the amounts are paid, and whether the contract under which the amount is paid is a per diem-type contract. A copy of the report must be provided to the payee by January 31 following the year of payment, showing the name of the payor and the aggregate amount of benefits paid to the individual during the calendar year. Failure to file the report or provide the copy to the payee is subject to the generally applicable penalties for failure to file similar information reports.

Explanation of Provision

The technical correction clarifies that the reporting requirements include the need to report the address and phone number of the information contact. This conforms these reporting requirements to the requirements of the Taxpayer Bill of Rights 2.

5. Consumer protection provisions for long-term care insurance contracts (sec. 1402(e) of the bill and sec. 7702B(g)(4)(b) of the Code)

Present Law

The long-term care insurance rules of present law include consumer protection provisions (sec. 7702B(g)). Among these provisions is a requirement that the issuer of a contract offer to the policyholder a nonforfeiture provision that meets certain requirements. The requirements include a rule that the nonforfeiture provision shall provide for a benefit available in the event of a default in the payment of any premiums and the amount of the benefit may be adjusted subsequent to being initially granted only as necessary to reflect changes in claims, persistency, and interest as reflected in changes in rates for premium paying policies approved by the Secretary for the same contract form.

Explanation of Provision

The technical correction clarifies that the nonforfeiture provision shall provide for a benefit available in the event of a default in the payment of any premiums and the amount of the benefit may be adjusted subsequent to being initially granted only as necessary to reflect changes in claims, persistency, and interest as reflected in changes in rates for premium paying policies approved by the appropriate State regulatory authority (not by the Secretary) for the same contract form.

6. Insurable interests under the COLI provision (sec. 1402(f)(1) of the bill and sec. 264(a)(4) of the Code)

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer (the COLI rule). An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

Explanation of Provision

The technical correction is intended to prevent unintended avoidance of the COLI rule by clarifying that the rule relates to life insurance policies or annuity or endowment contracts covering any individual who (1) is or was an officer or employee of, or (2) is or was financially interested in, any trade or business carried on currently or formerly by the taxpayer. Thus, for example, the provision would clarify the treatment of interest on debt with respect to contracts covering former employees of the taxpayer. As another example, the provision would clarify the treatment of interest on debt with respect to a business formerly conducted by the taxpayer and transferred to an affiliate of the taxpayer. No inference is intended as the interpretation of this provision under prior law.

7. Applicable period for purposes of applying the interest rate for a variable rate contract under the COLI rules (sec. 1402(f)(2) of the bill and sec. 264(d)(2)(B)(ii) of the Code)

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

This provision generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986. If the policy loan interest rate under such a contract does not provide for a fixed rate of interest, then interest on such a contract paid or accrued after December 31, 1995, is allowable only to the extent the rate of interest for each fixed period selected by the taxpayer does not exceed Moody's Corporate Bond Yield Average—Monthly Average Corporates, for the third month preceding the first month of the fixed period. The fixed period must be 12 months or less.

Explanation of Provision

The technical correction provides that an election of an applicable period for purposes of applying the interest rate for a variable rate contract can be made no later than the 90th date after the date of enactment of the proposal, and applies to the taxpayer's first taxable year ending on or after October 13, 1995. If no election is made, the applicable period is the policy year. The policy year is the 12-month period beginning on the anniversary date of the policy.

8. Definition of 20-percent owner for purposes of key person exception under COLI rule (sec. 1402(f)(3) of the bill and sec. 264(d)(4) of the Code)

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) 5 individuals, or (2) the lesser of 5 percent of the total number of officers and employees of the taxpayer, or 20 individuals. Employees are to be full-time employees, for this purpose. A 20-percent owner is an individual who directly owns 20 percent or more of the total combined voting power of the corporation. If the taxpayer is not a corporation, the statute states that a 20-percent owner is an individual who directly owns 20 percent or more of the capital or profits interest of the employer.

Explanation of Provision

The technical correction clarifies that, in determining a key person, if the taxpayer is not a corporation, a 20-percent owner is an individual who directly owns 20 percent or more of the capital or profits interest of the taxpayer.

9. Effective date of interest rate cap on key persons and pre-1986 contracts under the COLI rule (sec. 1402(f)(4) of the bill and sec. 501(c) of HIPA)

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

This provision generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986. If the policy loan interest rate under such a contract does not provide for a fixed rate of interest, then interest on such a contract paid or accrued after December 31, 1995, is allowable only to the extent the rate of interest for each fixed period selected by the taxpayer does not exceed Moody's Corporate Bond Yield Average—Monthly Average Corporates, for the third month preceding the first month of the fixed period. The fixed period must be 12 months or less.

The interest rate cap on key persons and pre-1986 contracts is effective with respect to interest paid or accrued for any month beginning after December 31, 1995. Another part of the provision provides that the interest rate cap on key employees and pre-1986 contracts applies to interest paid or accrued after October 13, 1995.

Explanation of Provision

The technical correction clarifies that, under the COLI rule, the interest rate cap on key persons and pre-1986 contracts applies to interest paid or accrued for any month beginning after December 31, 1995. This technical correction eliminates the discrepancy between the October and the December dates in the grandfather rule for pre-1986 contracts.

10. Clarification of contract lapses under effective date provisions of the COLI rule (sec. 1402(f)(5) of the bill and sec. 501(d)(2) of HIPA)

Present Law

No deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance policies or annuity or endowment contracts owned by the taxpayer covering any individual who is (1) an officer or employee of, or (2) is financially interested in, any trade or business carried on by the taxpayer. An exception is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons, subject to an interest rate cap.

Additional limitations are imposed on the deductibility of interest with respect to single premium contracts, and interest on debt incurred or continued to purchase or carry a life insurance, endowment, or annuity contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract. An exception to the latter rule is provided, permitting deductibility of interest on bona fide debt that is part of such a plan, if no part of 4 of the annual premiums due during the first 7 years is paid by means of debt (the "4-out-of-7" rule).

Present law provides that the COLI rule is phased in. In connection with the phase-in rule, a transition rule provides that any amount included in income during 1996, 1997, or 1998, that is received under a contract described in the provision on the complete surrender, redemption or maturity of the contract or in full discharge of the obligation under the contract that is in the nature of a refund of the consideration paid for the contract, is includable ratably over the first 4 taxable years beginning with the taxable year the amount would otherwise have been includable. The lapse of a contract after October 13, 1995, due to nonpayment of premiums does not cause interest paid or accrued prior to January 1, 1999, to be nondeductible solely by reason of (1) failure to meet the 4-out-of-7 rule of present law, or (2) causing the contract to be treated as a single premium contract within the meaning of section 264(b)(1). This lapse provision states that the relief is provided in the following case: solely by reason of no additional premiums being received by reason of a lapse.

Explanation of Provision

The technical correction clarifies that, under the transition relief provided under the COLI rule, the 4-out-of-7 rule and the single premium rule of present law are not to apply solely by reason of a lapse occurring by reason of no additional premiums being received under the contract after October 13, 1995.

11. Requirement of gain recognition on certain exchanges (sec. 1402(g)(1) and (2) of the bill, sec. 511 of the Act, and sec. 877(d)(2) of the Code)

Present Law

Under the expatriation tax provisions in section 877, special tax treatment applies to certain former U.S. citizens and former long-term U.S. residents for 10 years following the date of loss of U.S. citizenship or U.S. residency status. Gain recognition is required on certain exchanges of property following loss of U.S. citizenship or U.S. residency status, unless a gain recognition agreement is entered into. In addition, regulatory authority is granted to apply this rule to the 15-year period beginning 5 years before the loss of U.S. citizenship or U.S. residency status.

Explanation of Provision

The technical correction clarifies that the period to which the general rule requiring gain recognition on certain exchanges applies is the 10-year period that begins on the date of loss of U.S. citizenship or U.S. residency status. In addition, the technical correction clarifies that in the case of an exchange occurring during the 5-year period before the loss of U.S. citizenship or U.S. residency status, any gain required to be recognized under regulations is to be recognized immediately after the date of such loss of U.S. citizenship.

12. Suspension of 10-year period in case of substantial diminution of risk of loss (sec. 1402(g)(3) of the bill, sec. 511 of the Act, and sec. 877(d)(3) of the Code)

Present Law

Under the expatriation tax provisions in section 877, special tax treatment applies to certain former U.S. citizens and former long-term U.S. residents for 10 years following the date of loss of U.S.

citizenship or U.S. residency status. The running of this period with respect to gain on the sale or exchange of any property is suspended for any period during which the individual's risk of loss with respect to the property is substantially diminished.

Explanation of Provision

The technical correction clarifies that the period to which the rule suspending such period in the case of a substantial diminution of risk of loss applies is the 10-year period that begins on the date of loss of U. S. citizenship or U.S. residency status.

13. Treatment of property contributed to certain foreign corporations (sec. 1402(g)(4) of the bill, sec. 511 of the Act, and sec. 877(d)(4) of the Code)

Present Law

Under the expatriation tax provisions in section 877, special tax treatment applies to certain former U.S. citizens and former long-term U.S. residents for 10 years following the date of loss of U.S. citizenship or U.S. residency status. Special rules apply in the case of certain contributions of U.S. property by such an individual to a foreign corporation during such period.

Explanation of Provision

The technical correction clarifies that the period to which the rule regarding certain contributions to foreign corporations applies is the 10-year period that begins on the date of loss of U.S. citizenship or U.S. residency status. The technical correction also clarifies that the rule applies in the case of property the income from which, immediately before the contribution, was from U.S. sources.

14. Credit for foreign estate tax (sec. 1402 (g)(6) of the bill, sec. 511 of the Act, and sec. 2107(c) of the Code)

Present Law

Under the expatriation tax provisions in section 2107, special estate tax treatment applies to certain former U.S. citizens and former long-term U.S. residents who die within 10 years following the date of loss of U.S. citizenship or U.S. residency status. Special rules provide a credit against the U.S. estate tax for foreign estate taxes paid with respect to property that is includible in the decedent's U.S. estate solely by reason of the expatriation estate tax provisions.

Explanation of Provision

The technical correction clarifies the formula for determining the amount of the foreign tax credit allowable against U.S. estate taxes on property includible in the decedent's U.S. estate solely by reason of the expatriation estate tax provisions. The credit for the estate taxes paid to any foreign country generally is limited to the lesser of (1) the foreign estate taxes attributable to the property includible in the decedent's U.S. estate solely by reason of the expatriation estate tax provisions or (2) the U.S. estate tax attributable to property that is subject to estate tax in such foreign country and is includible in the decedent's U.S. estate solely by reason of the expatriation tax provisions. The amount of taxes attributable to such property is determined on a pro rata basis.

III. TECHNICAL CORRECTIONS TO THE TAXPAYER BILL OF RIGHTS 2

1. Reasonable cause abatement for first-tier intermediate sanctions excise tax (sec. 1403(a) of the bill and section 4962 of the Code)

Present Law

Section 4958 imposes penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under sections 501(c)(3) or 501(c)(4) (other than private foundations) engage in an "excess benefit transaction." The excise tax may be imposed on certain disqualified persons (i.e., insiders) who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper.

A disqualified person who benefits from an excess benefit transaction is subject to a first-tier penalty tax equal to 25 percent of the amount of the excess benefit. Organization managers who participate in an excess benefit transaction knowing that it is improper are subject to a first-tier penalty tax of 10 percent of the amount of the excess benefit. Additional second-tier taxes equal to 200 percent of the amount of the excess benefit may be imposed on a disqualified person if there is no correction of the transaction within a specified time period.

Under section 4962, the IRS has the authority to abate certain first-tier taxes if the taxable event was due to reasonable cause and not to willful neglect and the event was corrected within the applicable correction period. First-tier taxes which may be abated include, among others, the taxes imposed under sections 4941 (on acts of self-dealing between private foundations and disqualified persons), 4942 (for failure by private foundations to distribute a minimum amount of income), and 4943 (on private foundations with excess business holdings).

In enacting the new excise taxes on excess benefit transactions, Congress explicitly intended to provide the IRS with abatement authority under section 4962.[150] However, the abatement rules of section 4962 apply only to qualified first-tier taxes imposed by subchapter A or C of Chapter 42. The section 4958 excise tax is located in subchapter D of Chapter 42. The failure to cross reference subchapter D in section 4962 means that IRS does not have such abatement authority with respect to the section 4958 excise taxes.

Explanation of Provision

The bill amends section 4962(b) to include a cross-reference to first-tier taxes imposed by subchapter D (i.e., the section 4958 excise taxes on excess benefit transactions). Thus, the IRS has authority to abate the first-tier excise taxes on excess benefit transactions in cases where it is established that the violation was due to reasonable cause and not due to willful neglect and the transaction at issue was corrected within the specified period.

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[150] See Ways and Means Committee Report 104-506 accompanying H.R. 2377, p. 59.

2. Reporting by public charities with respect to intermediate sanctions and certain other excise tax penalties (sec. 1403(b) of the bill and sec. 6033 of the Code)

Present Law

Section 4958 imposes penalty excise taxes as an intermediate sanction in cases where organizations exempt from tax under sections 501(c)(3) or 501(c)(4) (other than private foundations) engage in an "excess benefit transaction." The excise tax may be imposed on certain disqualified persons (i.e., insiders) who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper. No tax is imposed on the organization itself with respect under section 4958.

Section 4911 imposes an excise tax penalty on excess lobbying expenditures made by public charities. The tax is imposed on the organization itself. Section 4912 imposes a penalty excise tax on certain public charities that make disqualifying lobbying expenditures and section 4955 imposes a penalty excise tax on political expenditures of section 501(c)(3) organizations. Both of these penalty taxes are imposed not only on the affected organization, but also on organization managers who agree to an expenditure knowing that it is improper.

Under section 4962, the IRS has the authority to abate certain first-tier taxes if the taxable event was due to reasonable cause and not to willful neglect and the event was corrected within the applicable correction period. First-tier taxes which may be abated include, among others, the taxes imposed under section 4955.[151]

Under section 6033(b)(10), 501(c)(3) organizations are required to report annually on Form 990 any amounts paid by the organization under section 4911, 4912, and 4955. Thus, although sections 4912 and 4955 impose excise taxes on organization managers, organizations technically are not required to report any such excise taxes paid by such managers.

In addition, under section 6033(b)(11), an organization exempt from tax under section 501(c)(3) must report on Form 990 any amount of excise tax on excess benefit transactions paid by the organization, or any disqualified person with respect to such organization, during the taxable year. The Code does not explicitly require the reporting of any excess benefit excise taxes paid by an organization manager solely in his or her capacity as such (i.e., an organization manager might also be a disqualified person with respect to an excess benefit transaction, in which case any tax paid would be reported).

Explanation of Provision

The bill makes the reporting requirements of section 6033(b)(10) and (11) consistent with the excise tax penalty provisions to which they relate. Thus, section 6033(b)(10) is amended to require 501(c)(3) organizations to report any amounts of tax imposed under sections 4911, 4912, and 4955 on the organization or any organiza-

[151] A separate provision in the bill makes a technical correction to section 4962(b) to permit the abatement of first-tier penalty excise taxes imposed under section 4958.

tion manager of the organization. In addition, the bill requires reporting with respect to any reimbursements paid by an organization with respect to taxes imposed under sections 4912 or 4955 on any organization manager of the organization. Section 6033(b)(11) is amended to require 501(c)(3) organizations to report any amounts of tax imposed under section 4958 on any organization manager or any disqualified person, as well as any reimbursements of section 4958 excise tax liability paid by the organization to such organization managers or disqualified persons.

In addition, the bill clarifies that no reporting is required under sections 6033(b)(10) or (11) in the event a first-tier penalty excise tax imposed under section 4955 or section 4958 is abated by the IRS pursuant to its authority under section 4962.

IV. TECHNICAL CORRECTIONS TO OTHER ACTS

1. Correction of GATT interest and mortality rate provisions in the Retirement Protection Act (sec. 1404(b)(3) of the bill and sec. 1449(a) of the Small Business Act)

Present Law

The Retirement Protection Act of 1994, enacted as part of the implementing legislation for the General Agreements on Tariffs and Trade ("GATT"), modified the actuarial assumptions that must be used in adjusting benefits and limitations under section 415. In general, in adjusting a benefit that is payable in a form other than a straight life annuity and in adjusting the dollar limitation if benefits begin before age 62, the interest rate to be used cannot be less than the greater of 5 percent or the rate specified by the plan. Under GATT, the benefit is payable in a form subject to the requirements of section 417(e)(3), then the interest rate on 30-year Treasury securities is substituted for 5 percent. Also under GATT, for purposes of adjusting any limit or benefit, the mortality table prescribed by the Secretary must be used. This provision of GATT was generally effective as of the first day of the limitation year beginning in 1995.

The Small Business Act conformed the effective date of these changes to the effective date of similar changes by providing generally that, in the case of a plan that was adopted and in effect before December, 8, 1994, the GATT change is not effective with respect to benefits accrued before the earlier of (1) the later of the date a plan amendment applying the amendments is adopted or made effective or (2) the first day of the first limitation year beginning after December 31, 1999. The Small Business Act provides that "Determinations under section 415(b)(2)(E) before such earlier date are to be made with respect to such benefits on the basis of such section as in effect on December 7, 1994 (except that the modification made by section 1449(b) of the Small Business Job Protection Act of 1996 shall be taken into account), and the provisions of the plan as in effect on December 7, 1994, but only if such provisions of the plan meet the requirements of such section (as so in effect)."

Explanation of Provision

The provision in the Small Business Act was intended to permit plans to apply pre-GATT law under section 415(b)(2)(E) for a transition period. The bill conforms the statute to this intent by providing that determinations under section 415(b)(2)(E) before such earlier date are to be made with respect to such benefits on the basis of such section as in effect on December 7, 1994 and the provisions of the plan as in effect on December 7, 1994, but only if such provisions of the plan meet the requirements of such section (as so in effect).

2. Related parties determined by reference to section 267 (sec. 1404(d) of the bill and sec. 267(f) of the Code)

Present Law

Section 267 disallows losses arising in transactions between certain defined related parties. In the case of related corporations, such losses may be deferred. Several Code provisions, in defining related parties, often incorporate the relationships described in section 267 by cross-reference to such section.

Explanation of Provision

Any provision of the Internal Revenue Code of 1986 that refers to a relationship that would result in loss disallowance under section 267 also refers to relationships where loss is deferred, where such relationship is applicable to the provision.

III. BUDGET EFFECTS OF THE BILL

A. Committee Estimates

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the revenue reconciliation provisions in the bill.

ESTIMATED BUDGET EFFECTS OF RECOMMENDATIONS TO THE SENATE COMMITTEE ON THE BUDGET WITH RESPECT TO REVENUE RECONCILIATION PROVISIONS WITHIN THE JURISDICTION OF THE SENATE FINANCE COMMITTEE

Fiscal Years 1997 - 2007

[Millions of Dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
I. FAMILY TAX RELIEF PROVISIONS														
1. $500 tax credit for children under age 17 (under age 18 after 2002) (pro-rata $250 for 1997 for children under age 13); post-50% EIC, deposit requirement for age 13 to 16 (age 13 - 17 after 2002); $75,000/$110,000 phaseout; no indexing [1]	7/1/97	---	-10,598	-18,680	-18,379	-18,016	-17,836	-17,659	-18,284	-18,055	-17,828	-17,603	-83,509	-172,938
2. Individual AMT - annually increase exemption amounts by $600 joint/$450 single for 2001 and 2002; $950 joint/$700 single for 2003 and thereafter	tybo/a 1/1/01	---	---	---	---	-55	-295	-719	-1,428	-2,428	-3,955	-5,872	-350	-14,752
SUBTOTAL OF FAMILY TAX RELIEF PROVISIONS		**---**	**-10,598**	**-18,680**	**-18,379**	**-18,071**	**-18,131**	**-18,378**	**-19,712**	**-20,483**	**-21,783**	**-23,475**	**-83,859**	**-187,690**
II. EDUCATION TAX INCENTIVES														
1. Administration's HOPE scholarship tax credit as modified - drop B average requirement; credit is 50% of up to $3,000 (75% of up to $2,000 for students attending community colleges and technical schools) adjusted out-of-pocket tuition expenses to include books required for attendance (phaseout $40,000 - $50,000 singles/ $80,000 - $100,000 joint) [2]; require high school diploma or equivalent thereof to claim HOPE scholarship credit	pma & tyba 12/31/97	---	-1,531	-4,630	-4,689	-4,752	-4,822	-4,884	-4,935	-4,985	-5,035	-5,085	-20,425	-45,349
2. Student loan interest deduction ($2,500 above-the-line deduction; phaseout $40,000 - $50,000 singles/ $80,000 - $100,000 joint); deduction amounts are indexed; income limits indexed beginning in 2003	poida 12/31/97	---	-56	-176	-218	-274	-347	-386	-409	-434	-461	-490	-1,071	-3,251
3. Permanent extension of employer-provided educational assistance for graduates and undergraduates	tyba 12/31/96	---	-636	-660	-704	-745	-778	-813	-850	-888	-928	-972	-3,522	-7,972
4. Penalty-free IRA withdrawals for post-secondary and graduate education	tyba 12/31/97	---	-78	-201	-181	-175	-177	-179	-182	-184	-186	-189	-812	-1,732

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
5. Education IRAs - allow contributions of $500 child tax credit; and $2,000 nondeductible contributions; tax-free inside buildup; tax free withdrawals if used for tuition, room and board and graduate education; create prepaid plans for private education institutions ($2,000 per year) [3]	tyba 12/31/97	---	-211	-867	-1,224	-1,421	-1,510	-1,949	-2,376	-2,801	-3,232	-3,684	-5,233	-19,275
6. Allow tax-free withdrawals from qualified State-sponsored tuition programs; expanded to include room and board [3]	tyba 12/31/97	---	-60	-199	-216	-236	-258	-281	-308	-336	-368	-403	-969	-2,665
7. Repeal $150 million limit on tax-exempt section 501(c)(3) bonds for new capital expenditures	1/1/98	---	-6	-45	-75	-89	-99	-106	-115	-125	-138	-162	-315	-962
8. Remove expenses for teachers' training courses, approved by school board, from the 2% miscellaneous itemized deduction floor	tyba 12/31/97	---	-11	-23	-24	-25	-26	-27	-28	-30	-31	-32	-109	-256
9. Raise small issuer arbitrage rebate exception for governmental bonds used to finance education facilities from $5 million to $10 million	bia 12/31/97	---	-1	-4	-7	-11	-14	-27	-30	-33	-36	-38	-36	-199
SUBTOTAL OF EDUCATION TAX INCENTIVES		**---**	**-2,590**	**-6,805**	**-7,338**	**-7,728**	**-8,031**	**-8,652**	**-9,233**	**-9,816**	**-10,415**	**-11,055**	**-32,492**	**-81,661**
III. ECONOMIC GROWTH, SAVINGS AND INVESTMENT INCENTIVES														
1. Capital gains (a) 20%/10% rate structure; (b) retain maximum 28% for collectibles; (c) section 1250 recapture at maximum of 24%; (d) symmetric AMT treatment; (e) exclusion for gain on personal residence (including remainder interests)	5/7/97	1,292	6,961	-132	-3,202	-3,394	-3,548	-3,729	-3,953	-4,126	-4,348	-4,654	-3,315	-24,125
2. Qualified small business stock rules: extend present law to corporate investors, repeal the excluded gains from AMT, increase size of eligible business to $100 million, repeal pre-issue limitation, allow qualified tax-free rollover, other changes	various	---	-73	-129	-149	-171	-197	-226	-260	-299	-344	-396	-719	-2,244
3. Expand deductible IRAs - increase income limits by $10,000 for joint filers in 1998, 2000, 2002, and 2004 ($5,000 for single filers in 1998, 2000, 2002; $10,000 in 2004) and eliminate active spousal participant rules; create IRA Plus as in S. 197; penalty-free withdrawals for first-time home purchases capped at $10,000; and long-term unemployment [4]; permit IRAs to invest in bullion	tyba 12/31/97	---	-435	-459	-116	-978	-1,354	-2,070	-3,672	-4,384	-4,909	-5,473	-3,343	-23,850
SUBTOTAL OF ECONOMIC GROWTH, SAVINGS AND INVESTMENT INCENTIVES		**1,292**	**6,453**	**-720**	**-3,467**	**-4,543**	**-5,099**	**-6,025**	**-7,885**	**-8,809**	**-9,601**	**-10,523**	**-7,377**	**-50,219**

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
IV. ESTATE AND GIFT TAX PROVISIONS														
1. Increase unified estate and gift tax credit to $625,000 in 1998; $640,000 in 1999; $660,000 in 2000; $675,000 in 2001, $725,000 in 2002, $750,000 in 2003, $800,000 in 2004, $900,000 in 2005, and $1 million in 2006 and thereafter; index other provisions beginning in 1999	dda 12/31/97	---	---	-295	-557	-977	-1,277	-2,110	-2,912	-3,946	-5,677	-7,782	-3,106	-25,533
2. Exclude up to $1 million of qualified family farms and businesses	dda 12/31/97	---	---	-598	-702	-823	-957	-1,138	-1,327	-1,543	-1,686	-1,841	-3,080	-10,616
3. 20-year installment payment where estate consists largely of interest in closely held business	dda 12/31/97	---	---	---	---	---	---	-14	-10	-7	-5	-2	---	-38
4. No interest on certain portion of estate tax extended under section 6166 and interest rate reduced to 45% of present-law interest but nondeductible	dda 12/31/97	---	---	-10	-20	-32	-45	-59	-73	-88	-103	-119	-107	-549
5. Certain farmland cash rentals do not cause recapture of special valuation	roa 12/31/76	---	-25	-2	-2	-2	-2	-2	-2	-2	-2	-2	-33	-43
6. Expand exception from generation-skipping transfer tax for transfers to individuals with deceased parents	gsts DOE	---	---	-4	-4	-4	-4	-4	-5	-5	-5	-6	-16	-41
7. Exclude up to $1 million estate tax exclusion for treatment of land subject to a qualified conservation easement coordinated with exclusion of family farms and businesses (expanded treatment of land with severed mineral rights) business relief used	dda 12/31/97	---	---	-43	-48	-52	-55	-60	-64	-70	-75	-80	-198	-547
SUBTOTAL OF ESTATE AND GIFT TAX PROVISIONS		---	-25	-952	-1,333	-1,890	-2,340	-3,387	-4,393	-5,661	-7,553	-9,832	-6,540	-37,367
V. EXPIRING TAX PROVISIONS														
1. Contributions of appreciated stock to private foundations (through 12/31/99)	6/1/97	---	-40	-111	-81	-9	-2	---	---	---	---	---	-243	-243
2. Orphan drug tax credit (permanent)	6/1/97	---	-29	-28	-30	-32	-34	-35	-37	-39	-40	-42	-152	-346
3. Extend a modified work opportunity tax credit (through 7/31/99); include SSI recipients	wpoifhma 9/30/97	---	-201	-309	-259	-126	-49	-15	-2	---	---	---	-946	-963
4. R&E credit (through 12/31/99)	6/1/97	-161	-1,062	-1,821	-1,458	-700	-452	-259	-72	---	---	---	-5,293	-5,624
5. Extend wind and closed-loop biomass production credit for facilities placed in service before 7/1/01	DOE	---	---	1	-1	-5	-8	-8	-8	-8	-8	-8	-14	-54
SUBTOTAL OF EXPIRING TAX PROVISIONS		-161	-1,332	-2,068	-1,829	-874	-545	-317	-119	-47	-48	-50	-6,648	-7,230
VI. DISTRICT OF COLUMBIA TAX INCENTIVES [6]														
1. $5,000 credit for first-time homebuyer in D.C. (sunset 12/31/01)	po/a DOE	---	-23	-25	-25	-32	-19	[6]	[6]	[6]	[6]	[6]	-125	-125
2. 0% capital gains rate for new investment in qualified D.C. business property held for at least 5 years; sunset 12/31/02	1/1/98	---	-1	-9	-19	-34	-52	-76	-133	-142	-156	-167	-115	-790

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
3. $75 million in tax credits to taxpayers that provide equity and loans to certain D.C. businesses	1/1/98	---	-5	-10	-20	-25	-10	-2	-2	-1	[6]	[6]	-70	-75
SUBTOTAL OF DISTRICT OF COLUMBIA TAX INCENTIVES		**---**	**-29**	**-44**	**-64**	**-91**	**-81**	**-78**	**-135**	**-143**	**-156**	**-167**	**-310**	**-990**
VII. MISCELLANEOUS PROVISIONS														
1. Create Intercity Passenger Rail Fund [7]	10/1/97	---	-641	-653	-666	-363	---	---	---	---	---	---	-2,323	-2,323
2. Transfer 3.8 cents/gallon of the 4.3 cents/gallon transportation motor fuels tax on highway motor fuels to the Highway Trust Fund (through 4/15/01), and thereafter transfer 4.3 cents/gallon to the Highway Trust Fund	10/1/97	No Revenue Effect												
3. Provide an above-the-line deduction for certain State and local official's expenses	eii tybo/a 1/1/98	---	-2	-4	-4	-4	-5	-5	-6	-6	-7	-7	-19	-50
4. Repeal UBIT on income from an S corporation to an ESOP	tyba 12/31/97	---	-8	-23	-34	-41	-44	-46	-48	-50	-52	-54	-149	-400
5. Clarify tax-exempt status of certain State workmen's compensation funds	tyba 12/31/97	---	[6]	[6]	-1	-1	-1	-1	-1	-1	-1	-1	-2	-6
6. Clarify tax treatment of corporate sponsorship of charitable organization events	eca 12/31/97	Negligible Revenue Effect												
7. Raise the charitable mileage rate from 12 cents/mile to 15 cents/mile and index	tyba 12/31/97	---	-12	-83	-88	-97	-129	-140	-177	-192	-241	-288	-409	-1,447
8. Allow timeshare associations to elect to be taxed as homeowner associations at 32% rate and modify definition of property for timeshares	tyba 12/31/96	---	-1	-1	-1	-1	-2	-2	-2	-2	-2	-2	-7	-17
9. Modification of passive foreign investment company provisions to eliminate overlap with subpart F and to allow mark-to-market election	tyba 12/31/97	---	-23	-21	-22	-24	-25	-26	-27	-29	-31	-33	-115	-261
10. Foreign sales corporation benefits for computer software	gra 12/31/97	---	-27	-42	-146	-173	-180	-191	-202	-227	-252	-277	-568	-1,717
11. Exception from U.S. property definition under subpart F for certain securities positions	tyba 12/31/97	---	-1	-2	-2	-2	-2	-2	-2	-2	-2	-2	-9	-19
12. Direct Secretary of Treasury to limit treaty benefits for payments to certain hybrid entities	DOE	Negligible Revenue Effect												
13. Equalize the tax rates among alternative fuels except CNG	DOE	-2	-15	-16	-16	-17	-18	-19	-20	-21	-22	-23	-82	-186
14. Repeal excise tax on recreational motorboat diesel fuel	1/1/98	---	-4	-5	-5	-1	-1	-1	-1	-1	-1	-1	-16	-22
15. Expense "Brownfields" redevelopment costs in empowerment zones, enterprise communities and EPA demonstration sites	eia DOE	---	-35	-58	-58	-47	-48	-48	-47	-45	-45	-44	-247	-475
16. Reduce excise tax rate on draft cider to the small producer beer rate	10/1/97	---	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-3	-7
17. Clarify that capital gains from culled cows are not included in disqualified income for purposes of the EIC	tyba 12/31/95	---	-2	-1	-1	-1	-1	-1	-1	-1	-1	-1	-6	-13

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
18. Provide involuntary conversion tax treatment for livestock sold on account of certain weather-related conditions	sea 12/31/96	---	-12	-2	-2	-2	-1	-1	-1	-1	-1	-1	-18	-23
19. Reverse IRS position on AMT treatment of certain installment sales by farmers	di tyba 12/31/87	-8	-157	-158	-167	-164	-157	-148	22	22	21	21	-803	-864
20. Require study on simplified collection of distilled spirits taxes	---	No Revenue Effect												
21. Restore meals deduction to 80% in 5% increments every other year for persons subject to Federal hours of service limitation and Alaskan seafood processors; and clarify treatment of section 119 meals	tyba 12/31/97	---	-8	-17	-27	-38	-50	-63	-77	-92	-109	-126	-140	-607
22. Delay penalties for failure to make payments through EFTPS until after 6/30/98	DOE	No Revenue Effect												
23. Allow grandfathered publicly traded partnerships to elect to pay a PTP tax	tyba 12/31/97	Revenue Neutral												
24. Exempt multi-employer plans from section 415 percentage limitation	tyba 12/31/97	---	-2	-3	-3	-4	-4	-5	-5	-5	-5	-5	-16	-41
25. Clarify partial termination rules for Trans-Alaska pension trusts	---	Negligible Revenue Effect												
26. Montana simplified tax and wage reporting system (5-year demo)	---	No Revenue Effect												
27. Increase the size of projects financed with small-issue tax-exempt bonds to $20 million (keep bond cap at $10 million)	bia 12/31/97	---	[6]	-2	-5	-7	-9	-12	-14	-17	-20	-23	-24	-109
28. Purchasing of receivables by tax-exempt hospital cooperative service organizations	tyba 12/31/96	Negligible Revenue Effect												
29. Travel expenses of certain construction workers while working away from home	tyba 12/31/97	---	-4	-14	-15	-16	-17	-17	-18	-19	-20	-21	-66	-161
30. Worker classification of securities brokers	spa 12/31/97	Negligible Revenue Effect												
31. Provide safety net for marginal oil and gas production when crude oil annual average DRAC falls below $14	DOE	No Revenue Effect												
32. Loosen mortgage revenue bond requirements in Presidentially declared disaster areas for 2 years	[8]	---	-2	-5	-6	-6	-5	-5	-4	-4	-3	-3	-24	-43
33. Modification of empowerment zone and enterprise community criteria in the event of future designations of additional zones and communities	DOE	No Revenue Effect												
34. Exclusion of ministers from discrimination testing of nondenominational retirement plans	tyba 12/31/97	Negligible Revenue Effect												
35. Deduction for contributions made by ministers to retirement plans	tyba 12/31/97	Negligible Revenue Effect												
36. Treat service income of nonresident alien individuals earned on foreign ships as foreign source income and disregard the U.S. presence of such individuals	tyba 12/31/97	---	-2	-4	-3	-3	-3	-3	-3	-3	-3	-3	-15	-30

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
37. Exemption from subpart F for active financing income	tybi 1998	---	-23	-68	-3	---	---	---	---	---	---	---	-94	-94
38. Pension proposals:														
a. Spousal consent	pyba 12/31/97						Negligible Revenue Effect							
b. Increase in full funding limit	pyba 12/31/98	---	---	-5	-14	-16	-20	-21	-25	-25	-27	-27	-55	-180
39. Charitable contribution deduction for certain expenses incurred in support of Native Alaskan subsistence whaling	tybbo/a DOE	---	-1	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	-1	-3
40. Codify Bureau of Alcohol, Tobacco, and Firearms regulations on wine labeling	DOE						No Revenue Effect							
41. Require study of rate structure of vaccine excise tax	DOE						No Revenue Effect							
42. Exception from rule denying tax-exempt status to Federally guaranteed bonds for certain bonds receiving letter of credit backing from Federal Home Loan Banks	bia 12/31/97	---	[6]	-1	-1	-2	-2	-2	-3	-3	-3	-4	-6	-21
SUBTOTAL OF MISCELLANEOUS PROVISIONS		**-10**	**-983**	**-1,189**	**-1,291**	**-1,031**	**-725**	**-760**	**-663**	**-725**	**-828**	**-926**	**-5,217**	**-9,119**
VIII. REVENUE OFFSETS														
1. Extension of Airport and Airway Trust Fund excise taxes through 9/30/07; modify airline ticket tax deposit rule	10/1/97	-1,017	6,255	5,521	5,865	3,620	9,220	7,016	7,445	7,901	8,385	8,895	30,481	70,122
2. Reduce air passenger ticket tax rate from 10% to 7.5% of ticket price for flight segments to/from certain rural airports; and modify the definition of "rural airports" that qualify for a reduced ad valorem tax rate [9]	10/1/97	---	-28	-31	-32	-33	-34	-35	-36	-37	-38	-39	-158	-344
3. Increase international departure tax from $6.00 to $8.00, impose $8.00 tax on international arrivals, and impose 10% tax on portion of ticket price attributable to domestic segments of international flights (but retain present law for domestic flights to/from Alaska and Hawaii) [10]	10/1/97	---	590	657	694	734	776	821	867	914	965	1,018	3,451	8,037
4. Impose 10% tax on cash payments to airlines for air travel under credit card and similar programs	10/1/97	---	87	97	103	109	116	123	130	138	147	155	512	1,205
5. Require gain recognition for certain extraordinary dividends	da 5/3/95 da 9/13/95	---	44	-93	-54	-10	38	73	79	85	92	98	-75	352
6. Require gain recognition on certain distributions of controlled corporation stock (with modifications for intragroup distributions)	da 4/16/97	---	504	293	257	221	184	149	113	77	41	9	1,459	1,848
7. Require recognition of gain on certain appreciated positions in personal property	csa 6/8/97	---	367	121	68	73	79	85	94	111	118	127	708	1,243
8. Modify net operating loss carryback and carryover rules with the exception related to Presidentially declared disaster areas	NOLgi tyba DOE	---	42	303	361	256	179	136	112	100	93	90	1,141	1,672
9. Modify foreign tax credit carryover rules	ftpa tyba 12/31/97	---	80	520	468	441	416	390	275	271	267	263	1,925	3,391

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
10. Modify holding period for dividends-received deduction with 2 year transition period	droaa 30da DOE	---	1	3	15	16	16	16	17	17	17	18	51	136
11. Inclusion of income from notional principal contracts and stock lending transactions under subpart F	tyba DOE	---	9	20	21	21	21	21	22	22	22	23	91	202
12. Further restrict like-kind exchanges involving foreign personal property	Ta dofca	---	4	8	11	13	15	17	19	21	23	25	51	156
13. Extend LUST excise tax through 9/30/07	10/1/97	---	129	129	128	129	131	134	136	139	142	145	645	1,340
14. Treatment of preferred stock as "boot"	ta 6/8/97	---	35	37	39	41	43	10	10	11	11	12	194	248
15. Extend FUTA surtax and increase the statutory limit on the FUA Trust Fund from .25% of covered wages to .50% [11]	lpo/a 1/1/99	---	---	1,063	1,763	1,797	1,733	661	-73	-71	-74	-73	6,356	6,726
16. Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person	icoa dofca	---	1	4	6	8	11	13	15	17	19	21	30	115
17. Require registration of confidential corporate tax shelters; substantial understatement penalty	tsoaiTg	---	15	37	38	39	41	42	43	44	46	47	170	392
18. Information reporting on corporations receiving contract payments from certain Federal agencies	rd 90da DOE	---	---	7	8	9	10	11	11	12	12	13	34	93
19. Extend disclosure of tax return information for administration of certain Veterans' programs [11]	dma 9/30/98	---	---	22	27	31	36	36	37	38	38	39	116	304
20. Modify holding period for certain foreign tax credits	dpoaa 30da DOE	---	23	48	50	53	56	58	61	64	68	71	230	552
21. Reform tax treatment of redemptions involving related corporations	da/a 6/8/97	---	10	10	5	5	5	5	5	5	5	5	35	60
22. Restrict income forecast method and allow 3-year MACRS for rent-to-own property	tyba DOE	---	37	43	61	69	38	27	25	16	17	18	248	352
23. Gains or losses from certain terminations with respect to property	30da DOE	---	15	27	25	25	25	25	25	25	25	25	117	242
24. Interest on underpayment reduced by foreign tax credit carryback	ftpoa tyba DOE	---	8	10	2	1	1	1	1	1	1	1	22	27
25. Modify the basis allocation rules for distributee partners	pda DOE	---	26	52	55	57	59	61	64	66	69	72	249	581
26. Eliminate the substantial appreciation requirement for inventory of a partnership	sepda DOE	---	32	66	69	73	77	80	84	89	93	98	317	761
27. Extend UBIT rules to second tier subsidiaries of tax-exempt organizations and modify control test	tybe DOE & tyba 12/31/98	---	8	14	8	6	5	5	4	4	4	4	42	83
28. Carryover basis on sale of property by tax-exempt related party	sea 6/8/97	---	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	1	2
29. Modification of treatment of company-owned life insurance - pro rata disallowance of interest on debt to fund life insurance	cia 6/8/97	---	20	53	93	140	193	247	299	349	399	447	500	2,240
30. Termination of suspense accounts for family farm corporations required to use accrual method of accounting [13]	[14]	---	29	33	35	36	37	39	40	41	43	44	170	377
31. Repeal installment sales grandfather rules of 1986 Act	tyba 8/15/98	---	---	44	97	106	106	64	21	22	23	24	353	507

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
32. Repeal 1986 Act grandfather rules for pension business of Mutual of America	tyba 12/31/97	---	[12]	6	8	9	9	9	9	9	9	10	31	78
33. Apply 3% telephone excise tax to certain prepaid phone cards	DOE	---	19	28	38	49	60	71	83	101	113	124	193	684
34. Consistency requirement for returns of beneficiaries of estates and trusts	ria DOE	---	3	3	3	3	3	3	4	4	4	4	15	34
35. No information reporting on sales of principal residences less than $250,000 or $500,000 (married filing joint return)	DOE	Negligible Revenue Effect												
36. Determination of period of limitations relating to foreign tax credits	ftpoa tyba DOE	---	1	2	1	1	1	1	1	1	1	1	6	11
37. Uniform excise tax on vaccines; add 3 new vaccines ($0.84 per dose)	10/1/97	---	[6]	[12]	1	1	1	1	1	1	1	1	3	8
38. Increase the amount from $3,500 to $5,000 on involuntary cash out from pension plans	dma DOE	[12]	2	6	7	7	7	8	8	9	9	10	29	73
39. Repeal of 15% excess distribution and excess accumulation taxes	tyba & dda 12/31/96	---	-18	-19	-7	18	18	16	16	14	13	11	-8	62
40. Repeal special rule which permits certain companies to eliminate their AMT liability	tyba 12/31/97	---	2	5	5	5	5	5	5	5	5	5	22	47
41. Provide employers the option to offer tax-free employee parking or taxable cash compensation [15]	tyba 12/31/97	---	3	8	11	12	12	13	14	14	15	16	46	118
42. Replace truck tax deduction for tire value with tax credit for excise tax paid on tires	sa 1/1/1998	---	66	94	96	97	99	101	102	105	108	110	452	979
43. Increase of $0.20 per pack with proportionate increase in other tobacco products	10/1/97	---	2,980	2,949	2,960	2,972	2,983	2,993	3,003	3,014	3,026	3,037	14,844	29,917
44. Limitation on Charitable Remainder Trust annual payouts	tca DOE	---	1	1	1	1	1	1	1	1	1	1	5	10
45. Treatment of income from certain sales of inventory as U.S. source income	tyba DOE	---	3	7	8	9	10	11	15	13	14	15	37	105
46. Reduce ethanol income and excise tax subsidy from 54 cents/gallon to 53 cents/gallon for 2001 - 2002, 52 cents/gallon for 2003 - 2004, and 51 cents/gallon thereafter	1/1/01	---	---	---	---	10	14	25	29	40	45	45	24	208
47. Modify levy exemption and provide continuous levy on certain payments (without RRB beneficiaries)	lia DOE	---	328	323	252	212	156	117	101	85	81	77	1,271	1,732
48. Pension proposals:														
a. Increase in prohibited transactions excise tax	ptoa DOE	---	2	4	4	4	4	4	4	4	4	4	14	34
b. Basis recovery method	aba 12/31/97	---	1	3	6	9	11	15	18	21	24	27	30	133
SUBTOTAL OF REVENUE OFFSETS		-1,017	11,736	12,538	13,680	11,505	17,027	13,725	13,359	13,933	14,546	15,193	66,480	137,235
SIMPLIFICATION PROPOSALS		---	-179	-132	-144	-159	-171	-183	-199	-220	-236	-254	-792	-1,890
TECHNICAL CORRECTIONS		---	---	---	---	---	---	---	---	---	---	---	---	---

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
COMMITTEE AMENDMENT ON CHILD HEALTH		—	-1,000	-1,000	-2,000	-2,000	-2,000	—	—	—	—	—	-8,000	-8,000
NET TOTAL		104	1,453	-19,052	-22,165	-24,882	-20,096	-24,055	-28,980	-31,971	-36,074	-41,089	-84,755	-246,931

Source: Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

aba = annuities beginning after
bia = bonds issued after
cia = contracts issued after
csa = constructive sales after
da = distributions after
da/a = distributions and acquisitions after
dda = decedents dying after
di = dispositions in
dma = disclosures made after
DOE = date of enactment
dofca = date of first committee action
dpoaa = dividends paid or accrued after
droaa = dividends received or accrued after
eca = events conducted after
eia = expenses incurred after
eii = expenses incurred in
ftpa = foreign taxes paid or accrued in
ftpoa = foreign taxes paid or accrued in

gra = gross receipts after
gsta = generation skipping transfers after
icoa = involuntary conversions occurring after
lia = levies issued after
lpo/a = labor performed on or after
NOLgi = net operating losses generated in
pda = partnership distributions after
po/a = purchases on or after
poida = payments of interest due after
pma = payments made after
ptoa = prohibited transactions occurring after
pyba = plans years beginning after
rd = returns due
rfa = returns filed after
roa = rentals occurring after (for returns open on date of first committee action)
sa = sales after

sea = sales or exchanges after
sepda = sales and exchanges, and certain partnership distributions after
spa = services performed after
ta = transactions after
Ta = transfers after
tca = trusts created after
tyba = taxable years beginning after
tybi = taxable years beginning in
tybbo/a = taxable years beginning before, on or after
tybo/a = taxable years beginning on or after
tyea = taxable years ending after
tsoaiTg = tax shelters offered after issuance of Treasury guidance
wpoifhma = wages paid or incurred for hires made after
30da = 30 days after
90da = 90 days after

[1] Estimate considers interaction with HOPE tax credit proposal.
[2] Estimate includes interaction with employer education.
[3] Estimate includes interaction with estate and gift taxes.
[4] Estimate includes interaction with education IRAs.
[5] All D.C. tax initiatives are contingent on the creation of an Economic Development Corporation in 1997; estimate assumes creation of such an Economic Development Corporation and enactment of reforms to D.C. borrowing authority similar to that in the Administration's proposal.
[6] Loss of less than $500,000.
[7] This provision would transfer net revenues from 0.5 cents/gallon of the excise taxes on all transportation motor fuels to the fund. The provision has no revenue effect. Federal outlays would increase by $2.3 billion over fiscal years 1998 - 2001. Negative numbers in the table show the budget effect of the increase in outlays. Estimate provided by the Congressional Budget Office.
[8] Effective for bonds issued after 12/31/96 and bonds issued before 1/1/99.
[9] Rural airports would be defined as airports receiving "essential air service" assistance on date of enactment and having fewer than 100,000 enplanements in the previous calendar year, and (2) other airports having fewer than 100,000 passenger enplanements in the previous calendar year, excluding those within 75 miles of airports having more than 100,000 passenger enplanements in the previous year.
[10] Under present law, domestic flight to or from Alaska or Hawaii are subject to a $6.00 departure tax plus a 10% tax on the portion of ticket price attributable to the portion of flight over land.
[11] Estimate provided by the Congressional Budget Office.
[12] Gain of less than $500,000.
[13] Balances in new accounts would be included in income over a 10-year period, and balances in existing accounts over a 20-year period. For existing accounts, the amounts included in income in any year would not exceed 50% of the taxable income of the taxpayer before the inclusion. The provision would eliminate the present-law requirement that a portion of the suspense account be restored to income whenever the gross receipts of the corporation decline.
[14] Provision would be effective for taxable years ending after the date of first committee action, for new suspense accounts, and taxable years beginning after that date for existing accounts.
[15] Estimate does not include increase in receipts to Social Security trust fund ($21 million for 1997 - 2002; $51 million for 1997 - 2007).

B. Budget Authority and Tax Expenditures

Budget authority

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the revenue reconciliation provisions of the bill involve new budget authority with respect to the funding of the new Intercity Passenger Rail Fund.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the income tax reduction provisions generally involve increased tax expenditures and that the income tax increase provisions generally involve decreased tax expenditures. (See revenue table in Part III.A., above.) Non-income tax provisions are not classified as tax expenditures under the Budget Act. Certain of the compliance-related income tax and simplification provisions do not involve tax expenditures.

C. Consultation With Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office has submitted the following statement with respect to the Committee's revenue reconciliation provisions.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 20, 1997.

Hon. WILLIAM V. ROTH, Jr.,
Chairman, Committee on Finance
U.S. Senate, Washington, DC

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for the revenue reconciliation recommendations of the Senate Committee on Finance.

The estimate shows the budgetary effects of the committee's proposals over the 1998–2007 period. CBO understands that the Committee on the Budget will be responsible for interpreting how these proposals compare with the reconciliation instructions in the budget resolution.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Stephanie Weiner.

Sincerely,

PAUL VAN DE WATER
(For June E. O'Neil, Director).

Enclosures.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

Revenue Reconciliation Recommendations of the Senate Committee on Finance

Summary: The revenue reconciliation provisions recommended by the Committee on Finance would make many changes to the Internal Revenue Code. A new credit for children under age 17 would result in the largest reduction in revenue. Other major reductions in revenue would result from a new tax credit for students, changes in IRAs, educational investment accounts, lower taxation of capital gains realizations, and modifications to the alternative minimum tax and to the estate and gift tax. The provisions also include changes that would generate revenue. About half of the extra revenue would come from extending and modifying aviation excise taxes. In addition, the excise tax on cigarettes would be increased by 20 cents per pack.

Estimated cost to the Federal Government: The Joint Committee on Taxation (JCT) provided estimates for most of the revenue reconciliation provisions, and CBO concurs with their estimates. CBO and JCT estimate that these provisions would reduce governmental receipts by $74.5 billion over the 1997–2002 period. In addition, CBO estimates that the bill, including the committee amendment on child health, would increase direct spending by $7.9 billion in fiscal year 1999 through 2002. The provision establishing the Intercity Passenger Rail Fund would be financed with receipts from a half-cent of the 4.3 cents-per gallon excise tax. Based on JCT estimates, CBO estimates that this legislation would dedicate revenues of $2.3 billion to this fund for the 1998 to 2001 period. Please refer to the enclosed CBO and JCT tables for a more detailed estimate of the provisions.

Intergovernmental and private-sector impact: In accordance with the requirements of Public Law 104–4, the Unfunded Mandates Reform Act of 1995, JCT has determined that the bill contains several private-sector mandates. Please refer to the enclosed letter for a more detailed account of these provisions. These provisions would impose direct costs on the private sector of more than $100 million in each year from 1998–2002. The JCT estimates the direct mandate cost of tax increases in the bill would total $10.8 billion in 1998, and $61.1 billion over the 1998–2002 period, as shown below:

ESTIMATED FEDERAL PRIVATE-SECTOR MANDATE IMPACT OF THE REVENUE RECONCILIATION RECOMMENDATIONS OF THE SENATE COMMITTEE ON FINANCE

[By fiscal year, in billions of dollars]

	1998	1999	2000	2001	2002
Private Sector Mandates	10.752	11.442	12.600	10.441	15.993

In addition, JCT has determined that the provision to extend and modify the Airport and Airway Trust Fund excise taxes and the provision to modify the vaccine excise tax may impose an intergovernmental mandate on State, local, and tribal governments. JCT estimates that the direct cost of complying with these intergovernmental mandates will not exceed $50 million in either the first fiscal year or in any of the 4 fiscal years following the first fiscal year.

Estimate prepared by: Stephanie Weiner.

Estimate approved by: Rick Kasten, Deputy Assistant Director for Tax Analysis.

APPENDIX TABLE
ESTIMATED BUDGETARY EFFECTS OF THE REVENUE RECONCILIATION RECOMMENDATIONS OF THE SENATE COMMITTEE ON FINANCE
(in billions of dollars, by fiscal year)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-2002 Total	1998-2007 Total
CHANGES IN REVENUES													
On Budget Revenues a/	0.172	3.229	-17.211	-19.302	-22.313	-17.884	-23.832	-28.746	-31.73	-35.816	-40.819	-73.481	-234.615
Off Budget Revenues b/	-0.068	-0.134	-0.204	-0.220	-0.232	-0.243	-0.254	-0.265	-0.273	-0.290	-0.302	-1.033	-2.417
Total	0.104	3.095	-17.415	-19.522	-22.545	-18.127	-24.086	-29.011	-32.003	-36.106	-41.121	-74.514	-237.032
CHANGES IN DIRECT SPENDING													
Disclosure of Veteran's Information													
Medical Care Cost Recovery	0.000	0.000	-0.018	-0.019	-0.019	-0.020	-0.020	-0.021	-0.022	-0.022	-0.023	-0.076	-0.184
Veterans Pension Outlays	0.000	0.000	-0.004	-0.008	-0.012	-0.016	-0.016	-0.016	-0.016	-0.016	-0.016	-0.040	-0.120
Committee Amendment on Child Health	0.000	1.000	1.000	2.000	2.000	2.000	0.000	0.000	0.000	0.000	0.000	8.000	8.000
Total	0.000	1.000	0.978	1.973	1.969	1.964	-0.036	-0.037	-0.038	-0.038	-0.039	7.884	7.696
REVENUES DEDICATED TO INTERCITY PASSENGER RAIL RESERVE FUND													
Reserve Fund	0.000	0.641	0.653	0.666	0.363	0.000	0.000	0.000	0.000	0.000	0.000	2.323	2.323

a. Includes the revenue effect of the DC tax initiatives which are contingent upon the creation of an Economic Development Corporation in 1997; estimate assumes creation of such an Economic Development Corporation and enactment of reforms to D.C. borrowing authority similar to that in the Administration's proposal. Also includes the revenue effect of the unemployment compensation provisions in Title V of the reconciliation bill.

b. The following two provisions would affect social security revenues, which are off budget: employer-provided education assistance and employer provided parking.

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON TAXATION,
Washington, DC, June 20, 1997.

Mrs. JUNE O'NEIL,
Director, Congressional Budget Office, U.S. Congress, Washington, DC.

DEAR MRS. O'NEIL: The staff of the Joint Committee on Taxation has reviewed the revenue reconciliation provisions ordered to be reported by the Senate Committee on Finance on June 19, 1997. In accordance with the requirements of Public Law 104–4, the Unfunded Mandates Reform Act of 1995 (the "Unfunded Mandates Act"), we have determined that the following provisions contain Federal private sector mandates:

Extend Airport and Airway Trust Fund excise taxes through 9/30/07.

Require gain recognition for certain extraordinary dividends.

Require gain recognition on certain distributions of controlled corporation stock.

Require recognition of gain on certain appreciated positions in personal property.

Modify net operating loss carryover rules.

Modify foreign tax credit carryover rules.

Modify holding period for dividends received deduction.

Inclusion of income from notational principal contracts and stock lending transactions under subpart F.

Further restrict like-kind exchanges involving foreign personal property.

Extend LUST excise tax through 9/30/07.

Treatment of preferred stock as "boot".

Extend FUTA surtax.

Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person.

Require registration of confidential corporate tax shelters.

Modify holding period for certain foreign tax credits.

Reform tax treatment of redemptions involving related corporations.

Restrict income forecast method and allow 3-year MACRS for rent-to-own property.

Gains or losses from certain terminations with respect to property.

Interest on underpayment reduced by foreign tax credit carryback.

Modify the basis allocation rules for distributee partners.

Eliminate the substantial appreciation requirement for inventory of a partnership.

Extend UBIT rules to second tier subsidiaries of tax-exempt organizations and modify control test.

Carryover basis on sale of property by tax-exempt related party.

Modification of treatment of company-owned life insurance-prorata disallowance of interest on debt to fund life insurance.

Termination of suspense accounts for family farm corporations required to use accrual method of accounting.

Repeal installment sales grandfather rules of 1986 Act.

Repeal 1986 Act grandfather rules for pension business of Mutual of America.

Apply 3% telephone excise tax to certain prepaid phone cards.

Consistency requirement for returns of beneficiaries of estates and trusts.

Determination of period of limitations relating to foreign tax credits.

Uniform excise tax on vaccines, add 3 new vaccines ($0.84 per dose).

Repeal of 15% excess distribution and excess accumulation taxes.

Repeal special rule which permits certain companies to eliminate their AMT liability.

Replace truck tax deduction for tire value with tax credit for excise tax paid on tires.

Increase of $.20 per pack cigarette excise tax with proportionate increases in other tobacco products.

Limit charitable remainder trusts eligibility for certain trusts.

Treatment of income from certain sales of inventory as U.S. source income.

Reduce ethanol subsidy.

The attached revenue table (items indicated in bold) generally reflects amounts that are no greater than the aggregate estimated amounts that the private sector will be required to spend in order to comply with these Federal private sector mandates.

There are two provisions that may impose a Federal intergovernmental mandate on State, local, and tribal governments. These provisions are the following:

Extend Airport and Airways Trust Fund excise taxes.

Modify vaccine excise tax.

The staff of the Joint Committee on Taxation estimates that the direct costs of complying with these Federal intergovernmental mandates will not exceed $50,000,000 in either the first fiscal year or in any of the 4 fiscal years following the first fiscal year.

If you would like to discuss this information in further detail, please feel free to contact me at 225–3621. Thank you for your cooperation in this matter.

Sincerely,

KENNETH KIES,
Chief of Staff.

20-Jun-97 4:52pm

#97-2 164
VERY PRELIMINARY
20-Jun-97

ESTIMATED BUDGET EFFECTS OF RECOMMENDATIONS TO THE SENATE COMMITTEE ON THE BUDGET WITH RESPECT TO REVENUE RECONCILIATION PROVISIONS WITHIN THE JURISDICTION OF THE SENATE FINANCE COMMITTEE

Fiscal Years 1997 - 2007

[Millions of Dollars]

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
I. FAMILY TAX RELIEF PROVISIONS														
1. $500 tax credit for children under age 17 (under age 18 after 2002) (pro-rata $250 for 1997 for children under age 13); post-50% EIC, deposit requirement for age 13 to 16 (age 13 - 17 after 2002); $75,000/$110,000 phaseout; no indexing [1]	7/1/97	---	-10,598	-18,680	-18,379	-18,016	-17,836	-17,659	-18,284	-18,055	-17,828	-17,603	-83,509	-172,938
2. Individual AMT - annually increase exemption amounts by $600 joint/$450 single for 2001 and 2002; $950 joint/$700 single for 2003 and thereafter	tybo/a 1/1/01	---	---	---	---	-55	-295	-719	-1,428	-2,428	-3,955	-5,872	-350	-14,752
SUBTOTAL OF FAMILY TAX RELIEF PROVISIONS		---	-10,598	-18,680	-18,379	-18,071	-18,131	-18,378	-19,712	-20,483	-21,783	-23,475	-83,859	-187,690
II. EDUCATION TAX INCENTIVES														
1. Administration's HOPE scholarship tax credit as modified - drop B average requirement; credit is 50% of up to $3,000 (75% of up to $2,000 for students attending community colleges and technical schools) adjusted out-of-pocket tuition expenses to include books required for attendance (phaseout $40,000 - $50,000 singles/ $80,000 - $100,000 joint) [2]; require high school diploma or equivalent thereof to claim HOPE scholarship credit	pma & tyba 12/31/97	---	-1,531	-4,630	-4,689	-4,752	-4,822	-4,884	-4,935	-4,985	-5,035	-5,085	-20,425	-45,349
2. Student loan interest deduction ($2,500 above-the-line deduction; phaseout $40,000 - $50,000 singles/ $80,000 - $100,000 joint); deduction amounts are indexed; income limits indexed beginning in 2003	poida 12/31/97	---	-56	-176	-218	-274	-347	-386	-409	-434	-461	-490	-1,071	-3,251
3. Permanent extension of employer-provided educational assistance for graduates and undergraduates	tyba 12/31/96	---	-636	-660	-704	-745	-778	-813	-850	-888	-928	-972	-3,522	-7,972
4. Penalty-free IRA withdrawals for post-secondary and graduate education	tyba 12/31/97	---	-78	-201	-181	-175	-177	-179	-182	-184	-186	-189	-812	-1,732

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
5. Education IRAs - allow contributions of $500 child tax credit; and $2,000 nondeductible contributions; tax-free inside buildup; tax free withdrawals if used for tuition, room and board and graduate education; create prepaid plans for private education institutions ($2,000 per year) [3]	tyba 12/31/97	---	-211	-867	-1,224	-1,421	-1,510	-1,949	-2,376	-2,801	-3,232	-3,684	-5,233	-19,275
6. Allow tax-free withdrawals from qualified State-sponsored tuition programs; expanded to include room and board [3]	tyba 12/31/97	---	-60	-199	-216	-236	-258	-281	-308	-336	-368	-403	-969	-2,665
7. Repeal $150 million limit on tax-exempt section 501(c)(3) bonds for new capital expenditures	1/1/98	---	-6	-45	-75	-89	-99	-106	-115	-125	-138	-162	-315	-962
8. Remove expenses for teachers' training courses, approved by school board, from the 2% miscellaneous itemized deduction floor	tyba 12/31/97	---	-11	-23	-24	-25	-26	-27	-28	-30	-31	-32	-109	-256
9. Raise small issuer arbitrage rebate exception for governmental bonds used to finance education facilities from $5 muilon to $10 million	bia 12/31/97	---	-1	-4	-7	-11	-14	-27	-30	-33	-36	-38	-36	-199
SUBTOTAL OF EDUCATION TAX INCENTIVES		---	-2,590	-6,805	-7,338	-7,728	-8,031	-8,652	-9,233	-9,816	-10,415	-11,055	-32,492	-81,661
III. ECONOMIC GROWTH, SAVINGS AND INVESTMENT INCENTIVES														
1. Capital gains (a) 20%/10% rate structure; (b) retain maximum 28% for collectibles; (c) section 1250 recapture at maximum of 24%; (d) symmetric AMT treatment; (e) exclusion for gain on personal residence (including remainder interests)	5/7/97	1,292	6,961	-132	-3,202	-3,394	-3,548	-3,729	-3,953	-4,126	-4,348	-4,654	-3,315	-24,125
2. Qualified small business stock rules: extend present law to corporate investors, repeal the excluded gains from AMT, increase size of eligible business to $100 million, repeal pre-issue limitation, allow qualified tax-free rollover, other changes	various	---	-73	-129	-149	-171	-197	-226	-260	-299	-344	-396	-719	-2,244
3. Expand deductible IRAs - increase income limits by $10,000 for joint filers in 1998, 2000, 2002, and 2004 ($5,000 for single filers in 1998, 2000, 2002; $10,000 in 2004) and eliminate active spousal participant rules; create IRA Plus as in S. 197; penalty-free withdrawals for first-time home purchases capped at $10,000; and long-term unemployment [4]; permit IRAs to invest in bullion	tyba 12/31/97	---	-435	-459	-116	-978	-1,354	-2,070	-3,672	-4,384	-4,909	-5,473	-3,343	-23,850
SUBTOTAL OF ECONOMIC GROWTH, SAVINGS AND INVESTMENT INCENTIVES		1,292	6,453	-720	-3,467	-4,543	-5,099	-6,025	-7,885	-8,809	-9,601	-10,523	-7,377	-50,219

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
IV. ESTATE AND GIFT TAX PROVISIONS														
1. Increase unified estate and gift tax credit to $625,000 in 1998; $640,000 in 1999; $660,000 in 2000; $675,000 in 2001, $725,000 in 2002, $750,000 in 2003, $800,000 in 2004, $900,000 in 2005, and $1 million in 2006 and thereafter; index other provisions beginning in 1999	dda 12/31/97	---	---	-295	-557	-977	-1,277	-2,110	-2,912	-3,946	-5,677	-7,782	-3,106	-25,533
2. Exclude up to $1 million of qualified family farms and businesses	dda 12/31/97	---	---	-598	-702	-823	-957	-1,136	-1,327	-1,543	-1,686	-1,841	-3,080	-10,616
3. 20-year installment payment where estate consists largely of interest in closely held business	dda 12/31/97	---	---	---	---	---	---	-14	-10	-7	-5	-2	---	-38
4. No interest on certain portion of estate tax extended under section 6166 and interest rate reduced to 45% of present-law interest but nondeductible	dda 12/31/97	---	---	-10	-20	-32	-45	-59	-73	-88	-103	-119	-107	-549
5. Certain farmland cash rentals do not cause recapture of special valuation	roa 12/31/76	---	-25	-2	-2	-2	-2	-2	-2	-2	-2	-2	-33	-43
6. Expand exception from generation-skipping transfer tax for transfers to individuals with deceased parents	gsta DOE	---	---	-4	-4	-4	-4	-4	-5	-5	-5	-6	-16	-41
7. Exclude up to $1 million estate tax exclusion for treatment of land subject to a qualified conservation easement coordinated with exclusion of family farms and businesses (expanded treatment of land with severed mineral rights) business relief used	dda 12/31/97	---	---	-43	-48	-52	-55	-60	-64	-70	-75	-80	-198	-547
SUBTOTAL OF ESTATE AND GIFT TAX PROVISIONS		---	-25	-952	-1,333	-1,890	-2,340	-3,387	-4,393	-5,661	-7,553	-9,632	-6,540	-37,367
V. EXPIRING TAX PROVISIONS														
1. Contributions of appreciated stock to private foundations (through 12/31/99)	6/1/97	---	-40	-111	-81	-9	-2	---	---	---	---	---	-243	-243
2. Orphan drug tax credit (permanent)	6/1/97	---	-29	-28	-30	-32	-34	-35	-37	-39	-40	-42	-152	-346
3. Extend a modified work opportunity tax credit (through 7/31/99); include SSI recipients	wpoifhma 9/30/97	---	-201	-309	-259	-128	-49	-15	-2	---	---	---	-946	-963
4. R&E credit (through 12/31/99)	6/1/97	-161	-1,062	-1,621	-1,458	-700	-452	-259	-72	---	---	---	-5,293	-5,624
5. Extend wind and closed-loop biomass production credit for facilities placed in service before 7/1/01	DOE	---	---	1	-1	-5	-8	-8	-8	-8	-8	-8	-14	-54
SUBTOTAL OF EXPIRING TAX PROVISIONS		-161	-1,332	-2,068	-1,829	-874	-545	-317	-119	-47	-48	-50	-6,648	-7,230
VI. DISTRICT OF COLUMBIA TAX INCENTIVES [5]														
1. $5,000 credit for first-time homebuyer in D.C. (sunset 12/31/01)	po/a DOE	---	-23	-25	-25	-32	-19	[6]	[6]	[6]	[6]	[6]	-125	-125
2. 0% capital gains rate for new investment in qualified D.C. business property held for at least 5 years; sunset 12/31/02	1/1/98	---	-1	-9	-19	-34	-52	-76	-133	-142	-156	-167	-115	-790

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
3. $75 million in tax credits to taxpayers that provide equity and loans to certain D.C. businesses	1/1/98	---	-5	-10	-20	-25	-10	-2	-2	-1	[6]	[6]	-70	-75
SUBTOTAL OF DISTRICT OF COLUMBIA TAX INCENTIVES		---	-29	-44	-64	-91	-81	-78	-135	-143	-156	-167	-310	-990
VII. MISCELLANEOUS PROVISIONS														
1. Create Intercity Passenger Rail Fund [7]	10/1/97	---	-641	-653	-666	-363	---	---	---	---	---	---	-2,323	-2,323
2. Transfer 3.8 cents/gallon of the 4.3 cents/gallon transportation motor fuels tax on highway motor fuels to the Highway Trust Fund (through 4/15/01), and thereafter transfer 4.3 cents/gallon to the Highway Trust Fund	10/1/97	*No Revenue Effect*												
3. Provide an above-the-line deduction for certain State and local official's expenses	eii tybo/a 1/1/98	---	-2	-4	-4	-4	-5	-5	-6	-6	-7	-7	-19	-50
4. Repeal UBIT on income from an S corporation to an ESOP	tyba 12/31/97	---	-8	-23	-34	-41	-44	-46	-48	-50	-52	-54	-149	-400
5. Clarify tax-exempt status of certain State workmen's compensation funds	tyba 12/31/97	---	[6]	[6]	-1	-1	-1	-1	-1	-1	-1	-1	-2	-6
6. Clarify tax treatment of corporate sponsorship of charitable organization events	eca 12/31/97	*Negligible Revenue Effect*												
7. Raise the charitable mileage rate from 12 cents/mile to 15 cents/mile and index	tyba 12/31/97	---	-12	-83	-88	-97	-129	-140	-177	-192	-241	-288	-409	-1,447
8. Allow timeshare associations to elect to be taxed as homeowner associations at 32% rate and modify definition of property for timeshares	tyba 12/31/96	---	-1	-1	-1	-1	-2	-2	-2	-2	-2	-2	-7	-17
9. Modification of passive foreign investment company provisions to eliminate overlap with subpart F and to allow mark-to-market election	tyba 12/31/97	---	-23	-21	-22	-24	-25	-26	-27	-29	-31	-33	-115	-261
10. Foreign sales corporation benefits for computer software	gra 12/31/97	---	-27	-42	-146	-173	-180	-191	-202	-227	-252	-277	-568	-1,717
11. Exception from U.S. property definition under subpart F for certain securities positions	tyba 12/31/97	---	-1	-2	-2	-2	-2	-2	-2	-2	-2	-2	-9	-19
12. Direct Secretary of Treasury to limit treaty benefits for payments to certain hybrid entities	DOE	*Negligible Revenue Effect*												
13. Equalize the tax rates among alternative fuels except CNG	DOE	-2	-15	-16	-16	-17	-18	-19	-20	-21	-22	-23	-82	-186
14. Repeal excise tax on recreational motorboat diesel fuel	1/1/98	---	-4	-5	-5	-1	-1	-1	-1	-1	-1	-1	-16	-22
15. Expense "Brownfields" redevelopment costs in empowerment zones, enterprise communities and EPA demonstration sites	eia DOE	---	-35	-58	-58	-47	-48	-48	-47	-45	-45	-44	-247	-475
16. Reduce excise tax rate on draft cider to the small producer beer rate	10/1/97	---	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-3	-7
17. Clarify that capital gains from culled cows are not included in disqualified income for purposes of the EIC	tyba 12/31/95	---	-2	-1	-1	-1	-1	-1	-1	-1	-1	-1	-6	-13

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
18. Provide involuntary conversion tax treatment for livestock sold on account of certain weather-related conditions	sea 12/31/96	---	-12	-2	-2	-2	-1	-1	-1	-1	-1	-1	-18	-23
19. Reverse IRS position on AMT treatment of certain installment sales by farmers	di tyba 12/31/87	-8	-157	-158	-167	-164	-157	-148	22	22	21	21	-803	-864
20. Require study on simplified collection of distilled spirits taxes	---						No Revenue Effect							
21. Restore meals deduction to 80% in 5% increments every other year for persons subject to Federal hours of service limitation and Alaskan seafood processors; and clarify treatment of section 119 meals	tyba 12/31/97	---	-8	-17	-27	-38	-50	-63	-77	-92	-109	-126	-140	-607
22. Delay penalties for failure to make payments through EFTPS until after 6/30/98	DOE						No Revenue Effect							
23. Allow grandfathered publicly traded partnerships to elect to pay a PTP tax	tyba 12/31/97						Revenue Neutral							
24. Exempt multi-employer plans from section 415 percentage limitation	tyba 12/31/97	---	-2	-3	-3	-4	-4	-5	-5	-5	-5	-5	-16	-41
25. Clarify partial termination rules for Trans-Alaska pension trusts	---						Negligible Revenue Effect							
26. Montana simplified tax and wage reporting system (5-year demo)	---						No Revenue Effect							
27. Increase the size of projects financed with small-issue tax-exempt bonds to $20 million (keep bond cap at $10 million)	bia 12/31/97	---	[6]	-2	-5	-7	-9	-12	-14	-17	-20	-23	-24	-109
28. Purchasing of receivables by tax-exempt hospital cooperative service organizations	tyba 12/31/96						Negligible Revenue Effect							
29. Travel expenses of certain construction workers while working away from home	tyba 12/31/97	---	-4	-14	-15	-16	-17	-17	-18	-19	-20	-21	-66	-161
30. Worker classification of securities brokers	spa 12/31/97						Negligible Revenue Effect							
31. Provide safety net for marginal oil and gas production when crude oil annual average DRAC falls below $14	DOE						No Revenue Effect							
32. Loosen mortgage revenue bond requirements in Presidentially declared disaster areas for 2 years	[8]	---	-2	-5	-6	-6	-5	-5	-4	-4	-3	-3	-24	-43
33. Modification of empowerment zone and enterprise community criteria in the event of future designations of additional zones and communities	DOE						No Revenue Effect							
34. Exclusion of ministers from discrimination testing of nondenominational retirement plans	tyba 12/31/97						Negligible Revenue Effect							
35. Deduction for contributions made by ministers to retirement plans	tyba 12/31/97						Negligible Revenue Effect							
36. Treat service income of nonresident alien individuals earned on foreign ships as foreign source income and disregard the U.S. presence of such individuals	tyba 12/31/97	---	-2	-4	-3	-3	-3	-3	-3	-3	-3	-3	-15	-30

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
37. Exemption from subpart F for active financing income	tybi 1998	---	-23	-68	-3	---	---	---	---	---	---	---	-94	-94
38. Pension proposals:														
a. Spousal consent	pyba 12/31/97	Negligible Revenue Effect												
b. Increase in full funding limit	pyba 12/31/98	---	---	-5	-14	-16	-20	-21	-25	-25	-27	-27	-55	-180
39. Charitable contribution deduction for certain expenses incurred in support of Native Alaskan subsistence whaling	tybbo/a DOE	---	-1	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	-1	-3
40. Codify Bureau of Alcohol, Tobacco, and Firearms regulations on wine labeling	DOE	No Revenue Effect												
41. Require study of rate structure of vaccine excise tax	DOE	No Revenue Effect												
42. Exception from rule denying tax-exempt status to Federally guaranteed bonds for certain bonds receiving letter of credit backing from Federal Home Loan Banks	bia 12/31/97	---	[6]	-1	-1	-2	-2	-2	-3	-3	-3	-4	-6	-21
SUBTOTAL OF MISCELLANEOUS PROVISIONS		**-10**	**-983**	**-1,189**	**-1,291**	**-1,031**	**-725**	**-760**	**-663**	**-725**	**-828**	**-928**	**-5,217**	**-9,119**
VIII. REVENUE OFFSETS														
1. Extension of Airport and Airway Trust Fund excise taxes through 9/30/07; modify airline ticket tax deposit rule	10/1/97	-1,017	6,255	5,521	5,865	3,620	9,220	7,016	7,445	7,901	8,385	8,895	30,481	70,122
2. Reduce air passenger ticket tax rate from 10% to 7.5% of ticket price for flight segments to/from certain rural airports; and modify the definition of "rural airports" that qualify for a reduced ad valorem tax rate [9]	10/1/97	---	-28	-31	-32	-33	-34	-35	-36	-37	-38	-39	-158	-344
3. Increase international departure tax from $6.00 to $8.00, impose $8.00 tax on international arrivals, and impose 10% tax on portion of ticket price attributable to domestic segments of international flights (but retain present law for domestic flights to/from Alaska and Hawaii) [10]	10/1/97	---	590	657	694	734	776	821	867	914	965	1,018	3,451	8,037
4. Impose 10% tax on cash payments to airlines for air travel under credit card and similar programs	10/1/97	---	87	97	103	109	116	123	130	138	147	155	512	1,205
5. Require gain recognition for certain extraordinary dividends	da 5/3/95 da 9/13/95	---	44	-93	-54	-10	38	73	79	85	92	98	-75	352
6. Require gain recognition on certain distributions of controlled corporation stock (with modifications for intragroup distributions)	da 4/16/97	---	504	293	257	221	184	149	113	77	41	9	1,459	1,848
7. Require recognition of gain on certain appreciated positions in personal property	csa 6/8/97	---	367	121	68	73	79	85	94	111	118	127	708	1,243
8. Modify net operating loss carryback and carryover rules with the exception related to Presidentially declared disaster areas	NOLgi tyba DOE	---	42	303	361	256	179	136	112	100	93	90	1,141	1,672
9. Modify foreign tax credit carryover rules	ftpa tyba 12/31/97	---	80	520	468	441	416	390	275	271	267	263	1,925	3,391

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
10. Modify holding period for dividends-received deduction with 2 year transition period	droaa 30da DOE	---	1	3	15	16	16	16	17	17	17	18	51	136
11. Inclusion of income from notional principal contracts and stock lending transactions under subpart F	tyba DOE	---	9	20	21	21	21	21	22	22	22	23	91	202
12. Further restrict like-kind exchanges involving foreign personal property	Ta dofca	---	4	8	11	13	15	17	19	21	23	25	51	156
13. Extend LUST excise tax through 9/30/07	10/1/97	---	129	129	128	129	131	134	136	139	142	145	645	1,340
14. Treatment of preferred stock as "boot"	ta 6/8/97	---	35	37	39	41	43	10	10	11	11	12	194	248
15. Extend FUTA surtax and increase the statutory limit on the FUA Trust Fund from .25% of covered wages to .50% [11]	lpo/a 1/1/99	---	---	1,063	1,763	1,797	1,733	661	-73	-71	-74	-73	6,356	6,726
16. Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person	icoa dofca	---	1	4	6	8	11	13	15	17	19	21	30	115
17. Require registration of confidential corporate tax shelters; substantial understatement penalty	tsoaiTg	---	15	37	38	39	41	42	43	44	46	47	170	392
18. Information reporting on corporations receiving contract payments from certain Federal agencies	rd 90da DOE	---	---	7	8	9	10	11	11	12	12	13	34	93
19. Extend disclosure of tax return information for administration of certain Veterans' programs [11]	dma 9/30/98	---	---	22	27	31	36	36	37	38	38	39	116	304
20. Modify holding period for certain foreign tax credits	dpoaa 30da DOE	---	23	48	50	53	56	58	61	64	68	71	230	552
21. Reform tax treatment of redemptions involving related corporations	da/a 6/8/97	---	10	10	5	5	5	5	5	5	5	5	35	60
22. Restrict income forecast method and allow 3-year MACRS for rent-to-own property	tyba DOE	---	37	43	61	69	38	27	25	16	17	18	248	352
23. Gains or losses from certain terminations with respect to property	30da DOE	---	15	27	25	25	25	25	25	25	25	25	117	242
24. Interest on underpayment reduced by foreign tax credit carryback	ftpoa tyba DOE	---	8	10	2	1	1	1	1	1	1	1	22	27
25. Modify the basis allocation rules for distributee partners	pda DOE	---	26	52	55	57	59	61	64	66	69	72	249	581
26. Eliminate the substantial appreciation requirement for inventory of a partnership	sepda DOE	---	32	66	69	73	77	80	84	89	93	98	317	781
27. Extend UBIT rules to second tier subsidiaries of tax-exempt organizations and modify control test	tyba DOE & tyba 12/31/98	---	8	14	8	6	5	5	4	4	4	4	42	63
28. Carryover basis on sale of property by tax-exempt related party	sea 6/8/97	---	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	1	2
29. Modification of treatment of company-owned life insurance - pro rata disallowance of interest on debt to fund life insurance	cia 6/8/97	---	20	53	93	140	193	247	299	349	399	447	500	2,240
30. Termination of suspense accounts for family farm corporations required to use accrual method of accounting [13]	[14]	---	29	33	35	36	37	39	40	41	43	44	170	377
31. Repeal installment sales grandfather rules of 1986 Act	tyba 8/15/98	---	---	44	97	106	106	64	21	22	23	24	353	507

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
32. Repeal 1986 Act grandfather rules for pension business of Mutual of America	tyba 12/31/97	---	[12]	6	8	9	9	9	9	9	9	10	31	78
33. Apply 3% telephone excise tax to certain prepaid phone cards	DOE	---	19	28	38	49	60	71	83	101	113	124	193	684
34. Consistency requirement for returns of beneficiaries of estates and trusts	rfa DOE	---	3	3	3	3	3	3	4	4	4	4	15	34
35. No information reporting on sales of principal residences less than $250,000 or $500,000 (married filing joint return)	DOE	Negligible Revenue Effect												
36. Determination of period of limitations relating to foreign tax credits	ftpoa tyba DOE	---	1	2	1	1	1	1	1	1	1	1	6	11
37. Uniform excise tax on vaccines; add 3 new vaccines ($0.84 per dose)	10/1/97	---	[6]	[12]	1	1	1	1	1	1	1	1	3	8
38. Increase the amount from $3,500 to $5,000 on involuntary cash out from pension plans	dma DOE	[12]	2	6	7	7	7	8	8	9	9	10	29	73
39. Repeal of 15% excess distribution and excess accumulation taxes	tyba & dda 12/31/96	---	-18	-19	-7	18	18	16	16	14	13	11	-8	62
40. Repeal special rule which permits certain companies to eliminate their AMT liability	tyba 12/31/97	---	2	5	5	5	5	5	5	5	5	5	22	47
41. Provide employers the option to offer tax-free employee parking or taxable cash compensation [15]	tyba 12/31/97	---	3	8	11	12	12	13	14	14	15	16	46	118
42. Replace truck tax deduction for tire value with tax credit for excise tax paid on tires	sa 1/1/1998	---	66	94	96	97	99	101	102	105	108	110	452	979
43. Increase of $0.20 per pack with proportionate increase in other tobacco products	10/1/97	---	2,980	2,949	2,960	2,972	2,983	2,993	3,003	3,014	3,026	3,037	14,844	29,917
44. Limitation on Charitable Remainder Trust annual payouts	tca DOE	---	1	1	1	1	1	1	1	1	1	1	5	10
45. Treatment of income from certain sales of inventory as U.S. source income	tyba DOE	---	3	7	8	9	10	11	15	13	14	15	37	106
46. Reduce ethanol income and excise tax subsidy from 54 cents/gallon to 53 cents/gallon for 2001 - 2002, 52 cents/gallon for 2003 - 2004, and 51 cents/gallon thereafter	1/1/01	---	---	---	---	10	14	25	29	40	45	45	24	208
47. Modify levy exemption and provide continuous levy on certain payments (without RRB beneficiaries)	lia DOE	---	328	323	252	212	156	117	101	85	81	77	1,271	1,732
48. Pension proposals:														
a. Increase in prohibited transactions excise tax	ptoa DOE	---	2	4	4	4	4	4	4	4	4	4	14	34
b. Basis recovery method	aba 12/31/97	---	1	3	6	9	11	15	18	21	24	27	30	133
SUBTOTAL OF REVENUE OFFSETS		-1,017	11,736	12,538	13,680	11,505	17,027	13,725	13,359	13,933	14,546	15,193	66,480	137,235
SIMPLIFICATION PROPOSALS		---	-179	-132	-144	-159	-171	-183	-199	-220	-236	-254	-792	-1,890
TECHNICAL CORRECTIONS		---	---	---	---	---	---	---	---	---	---	---	---	---

Provision	Effective	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-02	1998-07
COMMITTEE AMENDMENT ON CHILD HEALTH		—	-1,000	-1,000	-2,000	-2,000	-2,000	—	—	—	—	—	-8,000	-8,000
NET TOTAL		104	1,453	-19,082	-22,166	-24,882	-20,096	-24,055	-28,980	-31,971	-36,074	-41,089	-84,755	-246,931

Source: Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

aba = annuities beginning after
bia = bonds issued after
cia = contracts issued after
csa = constructive sales after
da = distributions after
da/a = distributions and acquisitions after
dda = decedents dying after
di = dispositions in
dma = disclosures made after
DOE = date of enactment
dofca = date of first committee action
dposa = dividends paid or accrued after
drosa = dividends received or accrued after
eca = events conducted after
eia = expenses incurred after
eii = expenses incurred in
fipa = foreig⁻ taxes paid or accrued in
fipoa = foreign taxes paid or accrued in
gra = gross receipts after
gsta = generation skipping transfers after
icoa = involuntary conversions occurring after
lia = levies issued after
lpo/a = labor performed on or after
NOLgi = net operating losses generated in
pda = partnership distributions after
po/a = purchases on or after
poida = payments of interest due after
pma = payments made after
ptoa = prohibited transactions occurring after
pyba = plans years beginning after
rd = returns due
rfa = returns filed after
roa = rentals occurring after (for returns open
on date of first committee action)
sa = sales after
sea = sales or exchanges after
sepda = sales and exchanges, and certain
partnership distributions after
spa = services performed after
ta = transactions after
Ta = transfers after
tca = trusts created after
tyba = taxable years beginning after
tybi = taxable years beginning in
tybbo/a = taxable years beginning before, on or after
tybo/a = taxable years beginning on or after
tyea = taxable years ending after
tsoaITg = tax shelters offered after issuance of
Treasury guidance
wpoiihma = wages paid or incurred for hires made after
30da = 30 days after
90da = 90 days after

[1] Estimate considers interaction with HOPE tax credit proposal.
[2] Estimate includes interaction with employer education.
[3] Estimate includes interaction with estate and gift taxes.
[4] Estimate includes interaction with education IRAs.
[5] All D.C. tax initiatives are contingent on the creation of an Economic Development Corporation in 1997; estimate assumes creation of such an Economic Development Corporation and enactment of reforms to D.C. borrowing authority similar to that in the Administration's proposal.
[6] Loss of less than $500,000.
[7] This provision would transfer net revenues from 0.5 cents/gallon of the excise taxes on all transportation motor fuels to the fund. The provision has no revenue effect. Federal outlays would increase by $2.3 billion over fiscal years 1998 - 2001. Negative numbers in the table show the budget effect of the increase in outlays. Estimate provided by the Congressional Budget Office.
[8] Effective for bonds issued after 12/31/96 and bonds issued before 1/1/99.
[9] Rural airports would be defined as airports receiving "essential air service" assistance on date of enactment and having fewer than 100,000 enplanements in the previous calendar year, and (2) other airports having fewer than 100,000 passenger enplanements in the previous calendar year, excluding those within 75 miles of airports having more than 100,000 passenger enplanements in the previous year.
[10] Under present law, domestic flight to or from Alaska or Hawaii are subject to a $6.00 departure tax plus a 10% tax on the portion of ticket price attributable to the portion of flight over land.
[11] Estimate provided by the Congressional Budget Office.
[12] Gain of less than $500,000.
[13] Balances in new accounts would be included in income over a 10-year period, and balances in existing accounts over a 20-year period. For existing accounts, the amounts included in income in any year would not exceed 50% of the taxable income of the taxpayer before the inclusion. The provision would eliminate the present-law requirement that a portion of the suspense account be restored to income whenever the gross receipts of the corporation decline.
[14] Provision would be effective for taxable years ending after the date of first committee action, for new suspense accounts, and taxable years beginning after that date for existing accounts.
[15] Estimate does not include increase in receipts to Social Security trust fund ($21 million for 1997 - 2002; $51 million for 1997 - 2007).

IV. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of Rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the vote on the motion to approve the Committee's revenue reconciliation recommendations.

Vote on motion to report

The Committee's revenue reconciliation recommendations were approved by a roll call vote of 18 yeas and 2 noes (a quorum present). The roll call vote was as follows:

Yeas.—Roth, Chafee, Grassley, Hatch, D'Amato, Murkowski, Lott, Jeffords, Mack, Moynihan, Baucus, Rockefeller, Breaux, Conrad, Graham, Moseley-Braun, Bryan, Kerrey.

Noes.—Nickles, Gramm.

Votes on amendments

Votes on amendments were as follows:

Amendment by Mr. Gramm to transfer the 4.3-cents-per-gallon deficit reduction fuels tax to the Highway Trust Fund (with 0.5 cent per gallon going to the new Intercity Passenger Rail Fund) was passed by a roll call vote of 16 yeas and 5 noes.

Amendment by Mr. Mack to allow a one-time $5,000 first home buyer Federal income tax credit for the purchase of a principal residence in the District of Columbia (expiring in 2002) was passed by voice vote.

Amendment by Mr. Conrad to exempt Fannie Mae life insurance from COLI disallowance rule was defeated by voice vote.

Amendment by Mr. Grassley to extend and modify the current law partial excise tax exemption for ethanol was passed by a roll call vote of 16 yeas and 4 noes.

Amendment by Mr. Jeffords to strike the D.C. investment incentives (except for $5,000 first home buyer tax credit) and create a trust fund for District of Columbia school renovations was defeated by a roll call vote of 9 yeas and 11 noes.

Amendment by Mr. Gramm to eliminate IRA deposit requirement for the $500 child credit for children over age 12 and reduce the 1997 partial child credit to $180 was defeated by a roll call of 8 yeas and 12 noes.

Amendment by Mr. Chafee to replace the current work opportunity tax credit with a two-tiered system was passed by a roll call vote of 11 yeas and 9 noes.

Amendment by Mr. Graham to increase the small arbitrage rebate exemption to $25 million for qualified education facilities, provide a simplified 3-year safe harbor for exemption from the arbitrage rebate rules for financing the construction of qualified facilities, exclude up to $25 million in construction of qualified education facilities from the $10 million limit in the amount of bonds a governmental issuer may issue annually, create a category of exempt facility bonds for qualified education facilities and make it subject to a separate volume cap equal to $10 per capita per year, offset by a cutback in the Hope scholarship tax credit was defeated by a roll call vote of 10 yeas and 10 noes.

V. REGULATORY IMPACT AND OTHER MATTERS

A. Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as reported.

Impact on individuals and businesses

Title I of the revenue reconciliation provisions provides a new tax credit for families with children under age 17 beginning in 1997, and including age 17 after 2002. Title I also provides an increase in the individual alternative minimum tax (AMT) exemption level, beginning in 2001.

Title II provides several education tax incentives, including a new HOPE scholarship tax credit, an above-the-line deduction for student loan interest, permanent extension of the exclusion for employer-provided education assistance for undergraduate and graduate students, penalty-free withdrawals from IRAs for higher education expenses, exclusion from income of education distributions from qualified tuition programs, eligible educational institutions permitted to maintain qualified tuition programs, repeal of limitation on qualified 501(c)(3) bonds (other than hospitals), increase in arbitrage rebate exception for governmental bonds used to finance education facilities, and the 2-percent floor on miscellaneous itemized deductions not to apply to certain continuing education expenses of elementary and secondary school teachers.

Title III provides increased retirement savings incentives, including increased availability of the IRA deduction, establishment of nondeductible "IRA Plus" accounts, and permits distributions from certain retirement plans without penalty to purchase first homes and when unemployed. Title III also provides for reduced capital gains tax rates for individuals, modifications to the exclusion of gain on certain small business stock and rollover of gain from sale of qualified stock, and an increased exemption from tax for gain on sale of principal residences.

Title IV provides for estate and gift tax relief for families by increasing the unified credit exemption amount gradually and indexing certain provisions, exclusion for qualified family farms and businesses (up to $1 million), and certain other estate and gift tax changes.

Title V extends four expiring tax provisions: (1) research tax credit (through December 31, 1999); (2) contributions of appreciated stock to private foundations (through December 31, 1999); (3) work opportunity tax credit (through December 31, 1999); and (4) permanent extension of the orphan drug tax credit.

Title VI provides various tax incentives for certain District of Columbia investments and residents by designating existing D.C. enterprise communities and census tracts with greater than 35 percent poverty as the "D.C. Enterprise Zone," an exclusion for capital gains for new investment in qualified D.C. business property held for at least 5 years, and tax credits for taxpayers providing equity and loans to certain D.C. businesses.

Title VII provides various miscellaneous revenue provisions, including repeal of the excise tax on recreational motorboat diesel fuel, creating a new Intercity Passenger Rail Fund ("Rail Fund") financed by 0.5 cent of the current 4.3-cents-per-gallon General Fund excise tax on all motor fuels (October 1, 1997–April 15, 2001), transferring the 4.3-cents-per-gallon General Fund tax on motor fuels (other than the 0.5 cent per gallon going to the Rail Fund) to the Highway Trust Fund on October 1, 1997, adjusting the excise tax rates on propane, liquefied natural gas, and methanol from natural gas to reflect the respective energy equivalence of the fuels to the tax on gasoline, disaster relief provisions, waiver of penalty (through June 30, 1998) on small businesses not making electronic fund transfers of tax payments, minimum tax not to apply to farmers' installment sales, treatment of computer software as FSC export property, other foreign provisions, tax-exempt status for certain State worker's compensation funds, increase in the standard mileage expense deduction rate for charitable use of passenger automobile, and several other miscellaneous tax provisions.

Title VIII provides the revenue offset provisions for the bill. These include provisions relating to financial products, corporate provisions, extension and modifications of Airport and Airway Trust Fund excise taxes (through September 30, 2007) to finance the Federal Aviation Administration airport and airway programs, reinstatement (through September 30, 2007) of the prior-law 0.1-cent-per-gallon fuels tax for the Leaking Underground Storage Tank Trust Fund, an increase in tobacco excise tax rates, application of the existing 3-percent communications excise tax to long-distance prepaid telephone cards, several foreign tax provisions, and several other revenue-increase provisions.

Titles IX, X, XI, XII, and XIII provide various tax simplification provisions, many of which have been considered and passed by the Congress in the 104th Congress in the Balanced Budget Act of 1995, which was not enacted.

Title IX provides numerous foreign-related simplification provisions.

Title X provides simplification provisions relating to individuals, partnerships, real estate investment trusts, regulated investment companies, taxpayer protections, and businesses generally.

Title XI provides simplification provisions relating to estate and gift taxes.

Title XII provides simplification provisions relating to excise taxes, tax-exempt bonds, Tax Court procedures, and other matters.

Title XIII provides simplification provisions relating to pensions.

Finally, Title XIV provides technical corrections to certain recent tax legislation.

Impact on personal privacy and paperwork

The revenue reconciliation provisions will not adversely affect personal privacy. The provisions will result in some increased paperwork for individuals and businesses as they comply with the new or modified tax provisions. There are numerous tax simplification provisions, which will reduce paperwork for individuals and businesses.

B. Unfunded Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (P.L. 104–4).

The Committee has determined that the following provisions of the bill contain Federal mandates on the private sector:

Extend Airport and Airway Trust Fund excise taxes through 9/30/07.

Require gain recognition for certain extraordinary dividends.

Require gain recognition on certain distributions of controlled corporation stock.

Require recognition of gain on certain appreciated positions in personal property.

Modify net operating loss carryover rules.

Modify foreign tax credit carryover rules.

Modify holding period for dividends received deduction.

Inclusion of income from notational principal contracts and stock lending transactions under subpart F.

Further restrict like-kind exchanges involving foreign personal property.

Extend LUST excise tax through 9/30/07.

Treatment of preferred stock as "boot".

Extend FUTA surtax.

Expansion of requirement that involuntarily converted property be replaced with property acquired from an unrelated person.

Require registration of confidential corporate tax shelters.

Modify holding period for certain foreign tax credits.

Reform tax treatment of redemptions involving related corporations.

Restrict income forecast method and allow 3-year MACRS for rent-to-own property.

Gains or losses from certain terminations with respect to property.

Interest on underpayment reduced by foreign tax credit carryback.

Modify the basis allocation rules for distributee partners.

Eliminate the substantial appreciation requirement for inventory of a partnership.

Extend UBIT rules to second tier subsidiaries of tax-exempt organizations and modify control test.

Carryover basis on sale of property by tax-exempt related party.

Modification of treatment of company-owned life insurance-pro rata disallowance of interest on debt to fund life insurance.

Termination of suspense accounts for family farm corporations required to use accrual method of accounting.

Repeal installment sales grandfather rules of 1986 Act.

Repeal 1986 Act grandfather rules for pension business of Mutual of America.

Apply 3% telephone excise tax to certain prepaid phone cards.

Consistency requirement for returns of beneficiaries of estates and trusts.

Determination of period of limitations relating to foreign tax credits.

Uniform excise tax on vaccines, add 3 new vaccines ($0.84 per dose).

Repeal of 15% excess distribution and excess accumulation taxes.

Repeal special rule which permits certain companies to eliminate their AMT liability.

Replace truck tax deduction for tire value with tax credit for excise tax paid on tires.

Increase cigarette excise tax by $.20 per pack with proportionate increase in tax on other tobacco products.

Limit charitable remainder trusts eligibility for certain trusts.

Treatment of income from certain sales of inventory as U.S. source income.

Reduce ethanol subsidy.

The costs required to comply with each Federal private sector mandate generally are no greater than the estimated budget effects of the provision. Benefits from the provisions include improved administration of the Federal income tax laws and a more accurate measurement of income for Federal income tax purposes. In addition, the extension and modification of the Airport and Airway Trust Fund excise taxes are designed to fund Federal administration of the airways and other important air services. The Committee believes the benefits of the bill are greater than the costs required to comply with the Federal private sector mandates contained in the bill.

The revenue-raising provisions of the bill are used to offset partially the costs of a child credit for certain low- and middle-income taxpayers, tax incentives for higher education (including the Administration's HOPE credit), capital gains tax relief, reduced estate and gift taxes, alternative minimum tax relief, and other important tax incentives. These provisions are generally designed to ease the burdens of Federal income and estate taxation on individuals and small business and the revenue-raising provisions of the bill are critical to achieving these goals.

The provision to extend the Airport and Airway Trust Fund taxes and the modifications to the vaccine excise tax impose Federal intergovernmental mandates. The staff of the Joint Committee on Taxation estimates that the direct costs of complying with these Federal intergovernmental mandates will not exceed $50,000,000 in either the first fiscal year or in any one of the 4 fiscal years following the first fiscal year. The Committee intends that the Federal intergovernmental mandates be unfunded because, in the case of the Airport and Airway Trust Fund taxes, the mandates fund the maintenance of U.S. airports and airways and the Committee believes that it is appropriate for State, local, and tribal governments to bear their allocable share of the responsibility for such funding. In the case of the vaccine excise tax, the Committee believes it appropriate for all purchasers of vaccines to pay the excise tax, which is used to compensate victims for injuries suffered from vaccines.

The revenue provisions of the bill generally affect activities that are only engaged in by the private sector. The provision extending the Airport and Airway Trust Fund excise taxes and the modifications to the vaccine excise tax are imposed both on the private sector and on State, local, and tribal governments and, thus, do not affect the competitive balance between such governments and the private sector.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).

○