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REPORT
106–201

# TAX RELIEF EXTENSION ACT OF 1999

OCTOBER 26, 1999.—Ordered to be printed

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

# REPORT

[To accompany S. 1792]

The Committee on Finance reported an original bill (S. 1792) to amend the Internal Revenue Code of 1986 to extend expiring provisions, to fully allow the nonrefundable personal credits against regular tax liability, and for other purposes, having considered the same, reports favorably thereon and recommends that the bill do pass.

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79–010

## I. LEGISLATIVE BACKGROUND

*Committee markup*

The Senate Committee on Finance marked up an original bill (the “Tax Relief Extension Act of 1999”) on October 20, 1999, and ordered the bill favorably reported by a unanimous voice vote on October 20, 1999.

*Committee hearings*

The following tax-related Committee hearings were held during the 106th Congress:

- President’s fiscal year 2000 budget and tax proposals (February 2, 1999);

- Increasing savings for retirement (February 24, 1999);
- Education tax proposals (March 3, 1999);
- International tax issues relating to globalization (March 11, 1999);
- Complexity of the individual income tax (April 15, 1999); and
- Pension reform proposals (June 30, 1999).

## II. EXPLANATION OF THE BILL

### TITLE I. EXTENSION OF EXPIRED AND EXPIRING TAX PROVISIONS

### A. EXTEND MINIMUM TAX RELIEF FOR INDIVIDUALS (SEC. 101 OF THE BILL AND SECS. 24 AND 26 OF THE CODE)

#### PRESENT LAW

Present law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Except for taxable years beginning during 1998, these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax, determined without regard to the minimum tax foreign tax credit. For taxable years beginning during 1998, these credits are allowed to the extent of the full amount of the individual's regular tax (without regard to the tentative minimum tax).

An individual's tentative minimum tax is an amount equal to (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of other unmarried individuals; and (3) $22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

For families with three or more qualifying children, a refundable child credit is provided, up to the amount by which the liability for social security taxes exceeds the amount of the earned income credit (sec. 24(d)). For taxable years beginning after 1998, the refundable child credit is reduced by the amount of the individual's minimum tax liability (i.e., the amount by which the tentative minimum tax exceeds the regular tax liability).

REASONS FOR CHANGE

The Committee believes that middle-income families should be able to use the nonrefundable credits without limitations by reason of the minimum tax. This provision will result in significant simplification by reducing the number of individuals required to make AMT computations for purposes of determining their personal credits.

EXPLANATION OF PROVISION

The bill extends the provision that allows the nonrefundable credits to offset the individual's regular tax liability in full (as opposed to only the amount by which the regular tax exceeds the tentative minimum tax) to taxable years beginning in 1999 to 2000.

Under the bill, the refundable child credit will not be reduced by the amount of an individual's minimum tax in taxable years beginning in 1999 to 2000.

EFFECTIVE DATE

The provisions are effective for taxable years beginning in 1999 and 2000.

## B. Extend Exclusion for Employer-Provided Educational Assistance (sec. 102 of the bill and sec. 127 of the Code)

PRESENT LAW

Educational expenses paid by an employer for its employees are generally deductible to the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. The exclusion expired with respect to graduate courses June 30, 1996. With respect to undergraduate courses, the exclusion for employer-provided educational assistance expires with respect to courses beginning on or after June 1, 2000.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, 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 plan can be provided for the class of individuals consisting of more than 5-percent owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.[1] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the edu-

[1] These rules also apply in the event that section 127 expires and is not reinstated.

cation expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (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, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally 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.[2]

### 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 certainly whether the educational assistance is excludable from income. This uncertainty may lead to disputes between taxpayers and the Internal Revenue Service.

The Committee believes that reinstating the exclusion for graduate-level employer provided educational assistance will enable more individuals to seek higher education. Such education can increase individuals' job opportunities to help make America more competitive in the global market place.

The past experience of allowing the exclusion to expire and subsequently retroactively extending it has created burdens of 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. The Committee believes that uncertainty about the exclusion's future may discourage some employers from providing educational benefits. Thus, the Committee believes it appropriate to extend the provisions so that employers and employees can plan for some time into the future.

### EXPLANATION OF PROVISION

The provision reinstates the exclusion for employer-provided educational experience for graduate-level courses, and extends the exclusion, as applied to both undergraduate and graduate-level courses through 2000.

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[2] In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deducation only if such expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's AGI. The 2-percent floor limitation is disregarded in determining whether an item is excludable as a working condition fringe benefit.

EFFECTIVE DATE

The provision is effective with respect to undergraduate courses beginning after May 31, 2000, and before January 1, 2001. The provision is effective with respect to graduate-level courses beginning after December 31, 1999, and before January 1, 2001.

## C. Extension of Research and Experimentation Credit, Increase in the Rates for the Alternative Incremental Research Credit, and Expansion to Puerto Rico and U.S. Possessions (sec. 103 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 does not apply to amounts paid or incurred after June 30, 1999.

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

*Computation of allowable credit*

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

[3] A special rule is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm will be assigned a fixed-base percentage of 3 percent of 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-based percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

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

*Alternative incremental research credit regime*

Taxpayers are allowed to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer's average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer's current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime applies to the taxable year in which the election is made and all subsequent years (in the event that the credit subsequently is extended by Congress) unless revoked with the consent of the Secretary of the Treasury.

*Eligible expenditures*

Qualified research expenditures eligible for the research tax credit consist of: (1) "in-house" expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").[4]

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 but must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must involve a process of experimentation related to functional aspects, performance, reliability, or quality of a business component.

Expenditures attributable to research that is conducted outside the United States do not enter 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

[4] Under a special rule, 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 sec. 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

by any grant, contract, or otherwise by another person (or governmental entity).

*Relation to deduction*

Deduction 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

The Committee believes that increasing technological knowledge ultimately will lead to new and better products produced at lower costs. New and better products and lower production costs are the genesis of economic growth. For this reason, the Committee believes it is important to extend the research and experimentation tax credit.

In addition, the Committee believes the alternative incremental credit enacted in 1996 should be strengthened. The alternative incremental research credit was enacted to respond to the changing economic circumstances of many taxpayers which invest heavily in research. However, the Committee believes that, under current law, the alternative incremental research credit provides less of a research incentive than does the regular research and experimentation tax credit. Therefore, the Committee believes it is appropriate to increase the rate of the alternative incremental research credit.

Lastly, the Committee believes that qualified research expenditures incurred in Puerto Rico and other possessions should qualify for purposes of determination of the research credit, so long as such expenses are not otherwise related to credits allowable under sec. 30A ("Puerto Rico economic activity credit") or under sec. 936 ("Puerto Rico and possession tax credit.").

EXPLANATION OF PROVISION

The bill extends the research tax credit for 18 months—i.e., generally, for the period July 1, 1999, through December 31, 2000.

In addition, the bill increases the credit rate applicable under the alternative incremental research credit one percentage point per step, that is, from 1.65 percent to 2.65 percent when a taxpayer's current-year research expenses exceed a base amount of 1 percent but do not exceed a base amount of 1.5 percent; from 2.2 percent to 3.2 percent when a taxpayer's current-year research expenses exceed a base amount of 1.5 percent but do not exceed a base amount of 2 percent; and from 2.75 percent to 3.75 percent when a taxpayer's current-year research expenses exceed a base amount of 2 percent.

Lastly, the bill expands the definition of qualified research to include research undertaken in Puerto Rico and other possessions of the United States. However, any employee compensation or other expense claimed for computation of the research credit may not also be claimed for the purpose of any credit allowable under sec.

30A ("Puerto Rico economic activity credit") or under sec. 936 ("Puerto Rico and possession tax credit").

In extending the research credit, the Committee is concerned that the definition of qualified research be administered in a manner that is consistent with the intent Congress has expressed in enacting and extending the research credit. The Committee urges the Secretary to consider carefully the comments he has and may receive regarding proposed regulations relating to the computation of the credit under section 41(c) and the definition of qualified research under section 41(d). The Committee wishes to reaffirm that qualified research is research undertaken for the purpose of discovering new information which is technological in nature. Employing existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken for purposes of discovering information and satisfy the other requirements under section 41.

The Committee also is concerned about unnecessary and costly taxpayer record keeping burdens and reaffirms that eligibility for the credit is not intended to be contingent on meeting unreasonable record keeping requirements.

#### EFFECTIVE DATE

The extension of the research credit is effective for qualified research expenditures paid or incurred during the period July 1, 1999, through December 31, 2000. The increase in the credit rate under the alternative incremental research credit is effective for taxable years beginning after June 30, 1999. The expansion of qualified research to include research undertaken in any possession of the United States is effective for qualified research expenditures paid or incurred beginning after June 30, 1999.

### D. EXTEND EXCEPTIONS UNDER SUBPART F FOR ACTIVE FINANCING INCOME (SEC. 104 OF THE BILL AND SECS. 953 AND 954 OF THE CODE)

#### PRESENT LAW

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

Foreign personal holding company income generally consists of the following: (1) dividends, interest, royalties, rents, and annuities; (2) net gains from the sale or exchange of (a) property that gives rise to the preceding types of income, (b) property that does not give rise to income, and (c) interests in trusts, partnerships, and REMICs; (3) net gains from commodities transactions; (4) net gains from foreign currency transactions; (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

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

Temporary exceptions from foreign personal holding company income, foreign base company services income, and insurance income apply for subpart F purposes for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business (so-called "active financing income"). These exceptions are applicable only for taxable years beginning in 1999.[5]

With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit ("QBU") of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met. Additional exceptions from foreign personal holding company income apply for certain income derived by a securities dealer within the meaning of section 475 and for gain from the sale of active financing assets.

In the case of insurance, in addition to a temporary exception from foreign personal holding company income for certain income of a qualifying insurance company with respect to risks located within the CFC's country of creation or organization, certain temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch, provided certain requirements are met under each of the exceptions. Further, additional temporary exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country

[5] Temporary exceptions from the subpart F provisions for certain active financing income applied only for taxable years beginning in 1998. Those exceptions were extended and modified as part of the present-law provision.

other than the United States, provided that the requirements for these exceptions are met.

REASONS FOR CHANGE

In the Taxpayer Relief Act of 1997, one-year temporary exceptions from foreign personal holding company income were enacted[6] for income from the active conduct of an insurance, banking, financing, or similar business. In the Tax and Trade Relief Extension Act of 1998 (the "1998 Act"),[7] the Congress extended the temporary exceptions for an additional year, with certain modifications designed to treat various types of businesses with active financing income more similarly to each other than did the 1997 provision. The Committee believes that it is appropriate to extend the temporary exceptions, as modified in the 1998 Act, for another year.

EXPLANATION OF PROVISION

The bill extends for one year the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

EFFECTIVE DATE

The provision is effective only for taxable years of foreign corporations beginning in 2000, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

## E. Extend Suspension of Net Income Limitation on Percentage Depletion From Marginal Oil and Gas Wells (sec. 105 of the bill and sec. 613A of the Code)

PRESENT LAW

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

Special percentage depletion rules apply to oil and gas production from "marginal properties" (sec. 613A(c)(6)). Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property substantially all of the production from which during the calendar year is heavy oil. Stripper well property is property from which the average daily production

[6] The President canceled this provision in 1997 pursuant to the Line Item Veto Act. On June 25, 1998, the U.S. Supreme Court held that the cancellation procedures set forth in the Line Item Veto Act are unconstitutional. *Clinton* v. *City of New York,* 118 S. Ct. 2091 (June 25, 1998).

[7] Division J of H.R. 4328, Making Omnibus Consolidated and Emergency Supplemental Appropriations For Fiscal Year 1999.

is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Farenheit). Under one such special rule, the 100-percent-of-net-income limitation does not apply to domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

### REASONS FOR CHANGE

The Committee notes that oil is, and will continue to be, vital to the American economy. The Committee observes that low oil prices have created substantial economic hardship in the oil industry and particularly in those communities where the majority of jobs are related to the oil and gas industry. The current economic hardship in the industry could lead to business failures and job losses. The Committee finds it appropriate to extend the present-law rule suspending the 100-percent-of-net-income limitation with respect to oil and gas production from marginal wells. The Committee believes that by reducing current taxable income, less cash will have to be devoted to income tax payments, and the current cash position of many such businesses will improve, helping them weather this current economic storm.

### EXPLANATION OF PROVISION

The bill extends the present-law rule suspending the 100-percent-of-net-income limitation with respect to oil and gas production from marginal wells to include taxable years beginning after December 31, 1999, and before January 1, 2001.

### EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 1999.

## F. EXTEND THE WORK OPPORTUNITY TAX CREDIT (SEC. 106 OF THE BILL AND SEC. 51 OF THE CODE)

### PRESENT LAW

*In general*

The work opportunity tax credit ("WOTC") is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit generally is equal to a percentage of qualified wages. The credit percentage is 25 percent for employment of at least 120 hours but less than 400 hours and 40 percent for employment of 400 hours or more. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer.

Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual is $2,400. With respect to qualified summer youth employees, the maximum credit is 40 percent of up to $3,000 of qualified first-year wages, for a maximum credit of $1,200.

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

*Targeted groups eligible for the credit*

The eight targeted groups are: (1) families eligible to receive benefits under the Temporary Assistance for Needy Families (TANF) Program; (2) high-risk youth; (3) qualified ex-felons; (4) vocational rehabilitation referrals; (5) qualified summer youth employees; (6) qualified veterans; (7) families receiving food stamps; and (8) persons receiving certain Supplemental Security Income (SSI) benefits.

*Minimum employment period*

No credit is allowed for wages paid to employees who work less than 120 hours in the first year of employment.

*Expiration date*

The credit is effective for wages paid to, or incurred with respect to, qualified individuals who began work for the employer before July 1, 1999.

### REASONS FOR CHANGE

The Committee believes the preliminary experience of the WOTC is promising as an incentive for employers to hire individuals who are under-skilled, undereducated, or who generally may be less desirable (e.g., lacking in work experience) to employers. A temporary extension of this credit will allow the Congress and the Treasury and Labor Departments to continue to monitor the effectiveness of the credit.

### EXPLANATION OF PROVISION

The bill extends the WOTC for 18 months, so that the credit is available for eligible individuals who begin work for an employer before January 1, 2001. The bill also clarifies the definition of first year of employment for purposes of the WOTC.

### EFFECTIVE DATE

Generally, the provision is effective for wages paid to, or incurred with respect to, qualified individuals who begin work for the employer on or after July 1, 1999, and before January 1, 2001.

## G. EXTEND THE WELFARE-TO-WORK TAX CREDIT (SEC. 106 OF THE BILL AND SEC. 51A OF THE CODE)

### PRESENT LAW

The Code provides a tax credit to employer on the first $20,000 of eligible wages paid to qualified long-term family assistance ("TANF") recipients during the first two years of employment. The credit is 35 percent of the first $10,000 of eligible wages in the first year of employment and 50 percent of the first $10,000 of eligible wages in the second year of employment. The maximum credit is $8,500 per qualified employee.

Qualified long-term family assistance recipients are: (1) members of a family that has received family assistance for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of this credit) if they are hired within 2 years after the date that the 18-month total is reached; and (3) members of a family who are no longer eligible for family assistance because of either Federal or State time limits, if they are hired within 2 years after the Federal or State time limits made the family ineligible for family assistance.

Eligible wages include cash wages paid to an employee plus amounts paid by the employer for the following: (1) educational assistance excludable under a section 127 program (or that would be excludable but for the expiration of sec. 127); (2) health plan coverage for the employee, but not more than the applicable premium defined under section 4980B(f)4; and (3) dependent care assistance excludable under section 129.

The welfare to work credit is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after January 1, 1998, and before June 30, 1999.

### REASONS FOR CHANGE

The Committee believes that the credit should be temporarily extended to provide the Congress and the Treasury and Labor Departments a better opportunity to assess the operation and effectiveness of the credit in meeting its goals. When enacted in the Taxpayer Relief Act of 1997, the goals of the welfare-to-work credit ere: (1) to provide an incentive to hire long-term welfare recipients; (2) to promote the transition from welfare to work by increasing access to employment; and (3) to encourage employers to provide these individuals with training, health coverage, dependent care and ultimately better job attachment.

### EXPLANATION OF PROVISION

The bill extends the welfare-to-work credit for 18 months, so that the credit is available for eligible individuals who begin work for an employer before January 1, 2001.

### EFFECTIVE DATE

The provision is effective for wages paid or incurred to a qualified individual who begins work for an employer on or after July 1, 1999.

## H. EXTEND AND MODIFY TAX CREDIT FOR ELECTRICITY PRODUCED BY WIND AND CLOSED-LOOP BIOMASS FACILITIES (SEC. 107 OF THE BILL AND SEC. 45 OF THE CODE)

### PRESENT LAW

An income tax credit is allowed or the production of electricity from either qualified wind energy or qualified “closed-loop” biomass facilities (sec. 45).

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 close-loop biomass facility placed in service after December 31, 1992, and before July 1, 1999. The credit is allowable for production during the 10-year period after a facility is originally placed in service.

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 include the use of waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to 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. 28(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 over the greater of (1) 25 percent of the net regular tax liability above $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back one taxable year and carried forward 20 taxable years (sec. 39).

REASONS FOR CHANGE

The Committee believes that the credit provided under section 45 has been important to the development of environmentally friendly, renewable wind power and that extending the placed in service date will increase the further development of wind resources.

The Committee observes, however, that there is organic waste that is disposed of in an uncontrolled manner or burned in the open. Such organic waste can be a fuel source which, if utilized, can promote a cleaner environment. The Committee further observes that landfills produce methane as entombed garbage decays. Methane can be a valuable fuel but, if permitted to dissipate into the atmosphere, it may create environmental damage. The Committee believes that providing a credit to utilize these organic fuel sources can help produced needed electricity while providing environmental benefits for communities and the nation.

EXPLANATION OF PROVISION

The present-law tax credit for electricity produced by wind and closed-loop biomass is extended to include production from facilities placed in service after June 30, 1999, and before January 1, 2001. The present-law initial placed in-service date (January 1, 1993) for closed-loop biomass facilities and definition of a closed-loop biomass facility is modified to extend the credit to post-December 31, 1999, electricity production at existing facilities that are modified after December 31, 1992, to use closed-loop biomass (e.g., switchgrass) as a fuel co-fired with coal. Production at co-fired facilities is eligible without regard to whether the modification otherwise qualify the facility as having been newly placed in service under general income tax principles.

The proposal also modifies the tax credit to include electricity produced from poultry litter, for facilities placed in service after December 31, 1999, and before January 1, 2001. The credit for electricity produced from poultry litter is available to the lessor/operator of a qualified facility that is owned by a governmental entity.

The credit is expanded to include electricity produced from landfill gas, for electricity produced from facilities placed in service after December 31, 1999, and before January 1, 2001.

Finally, the credit is expanded to include electricity produced from certain other biomass (in addition to close-loop biomass and poultry waste). This additional biomass includes solid, nonhazardous, cellulose waste material which is segregated from other waste materials and which is derived from forest resources, but not including old-growth timber. The term also includes urban sources such as waste pallets, crates, manufacturing and construction wood waste, and tree trimmings, or agricultural sources (including grain, orchard tree crop, vineyard legumes, sugar, and other crop by-products or residues). The term does not include unsegregated municipal solid waste or paper that commonly is recycled. In the case of this additional biomass, the credit applies to electricity produced after December 31, 1999 from facilities that are placed in service before January 1, 2001 (including facilities placed in service before the date of enactment of this provision). As with closed-loop biomass facilities, the credit is allowed for electricity production attributable to this additional biomass produced at facilities that are co-fired with coal.

In the case of electricity produced from landfill gas or gas from other biomass eligible for a credit under Code section 29, the electricity production credit is available only if no section 29 credits have been claimed in the past on production from the gas production facility and if the owner of that facility irrevocably elects not to claim the section 29 credit with respect to any future production. Such an election attaches to the otherwise qualified gas production facility and is binding without regard to changes in ownership of the facility.

With this extension and expansion of the section 45 production credit, the Committee emphasizes its commitment to encouraging new, environmentally friendly technologies for the production of electricity. However, the Committee observes that there are many different policies that help promote a better environment for future generations to enjoy. Sometimes these other policies may conflict with the goals promoted by the section 45 production credit. For example in certain areas of the western United States, construction of wind turbines may pose a hazard to the endangered California condor. Even when creating more environmentally friendly electric power, qualified facilities can diminish our future by their encroachment on delicate habitats. The Committee strongly encourages Federal, State, and local officials to be cognizant of such concerns for the environment and ecosystems when approving the siting of facilities that quality for the section 45 production credit.

EFFECTIVE DATE

The provision is effective on the date of enactment.

## I. Expansion of Qualifying Sites for Expensing of Environmental Remediation Expenditures (sec. 108 of the bill and sec. 198 of the Code)

### PRESENT LAW

Taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (sec. 198). 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.

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 are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency ("EPA") Brownfields Pilots; (3) any population census tract with a poverty rate of 20 percent or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas.

Eligible expenditures are those paid or incurred before January 1, 2001.

### REASONS FOR CHANGE

The Committee would like to see more so-called "brownfield" sties brought back into productive use in the economy. Cleaning up such sites mitigates potential harms to public health and can help revitalize affected communities. The Committee seeks to encourage the clean up of contaminated sites. To achieve this goal, the Committee believes it is necessary to expand the set of brownfield sites that may claim the tax benefits of expending beyond the relatively narrow class of sites identified in the Taxpayer Relief Act of 1997.

### EXPLANATION OF PROVISION

The bill eliminates the targeted area requirement, thereby, expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate State environmental agency, but not those sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980.

### EFFECTIVE DATE

The provision to expand the class of eligible sites is effective for expenditures paid or incurred after December 31, 1999.

## J. Temporary Increase in Amount of Rum Excise Tax That is Covered Over the Puerto Rico and the U.S. Virgin Islands (sec. 109 of the bill and sec. 7652 of the Code)

### PRESENT LAW

A $13.50 per proof gallon[8] excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States (sec. 5001). The excise tax does not apply to distilled spirits that are exported from the United States or to distilled spirits that are consumed in U.S. possessions (e.g., Puerto Rico and the Virgin Islands).

The Code provides for coverover (payment) of $10.50 per proof gallon of the excise tax imposed on rum imported (or brought) into the United States (without regard to the country of origin) to Puerto Rico and the Virgin Islands (sec. 7652). Before 1984, the full amount of the excise tax ($10.50) was covered over to the treasuries of Puerto Rico and the Virgin Islands. However, since 1983, the excise tax has been increased to $13.50 without a corresponding increase in the amount covered over being provided. During the five-year period ending on September 30, 1998, the amount covered over was $11.30 per proof gallon. This temporary increase was enacted in 1993 as transitional relief accompanying a reduction in certain tax benefits for corporations operating in Puerto Rico and the Virgin Islands (sec. 936).

Amounts covered over to Puerto Rico and the Virgin Islands are deposited in the treasuries of the two possessions for use as those possessions determine.

### REASONS FOR CHANGE

The Committee finds that the fiscal needs of Puerto Rico and the Virgin Islands remain substantial and, therefore, finds it appropriate to increase to the full amount of the tax the amount covered over to Puerto Rico and the Virgin Islands from rum imported (or brought) into the United States.

In addition, the Committee finds the need for natural resource protection in Puerto Rico to be urgent. Puerto Rico has a population density of more than 1,000 persons per square mile. The pressure on this small island's remaining open land and biodiversity is great. The Puerto Rico Conservation Trust is a private, nonprofit section 501(c)(3) organization operating in Puerto Rico. The Puerto Rico Conservation Trust is the principal organization involved in land and marine conservation projects in Puerto Rico. It currently manages 14 nature reserves on the island and has acquired or protected over 13,000 acres of land. Because of the unique role of the Puerto Rico Conservation Trust in natural and historic preservation in Puerto Rico, the Committee finds it appropriate to direct a portion of the cover to over to the Puerto Rico Conservation Trust for an 18-month period to help address the need for natural resource protection in Puerto Rico.

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[8] A proof gallon is a liquid gallon consisting of 50 percent alcohol.

EXPLANATION OF PROVISION

The provision increases from $10.50 to $13.50 per proof gallon the amount of excise taxes collected on rum brought into the United States that is covered over to Puerto Rico and the U.S. Virgin Islands.

The provision provides that $0.50 per proof gallon of the amount covered over to Puerto Rico will be transferred to the Puerto Rico Conservation Trust, a private, non-profit section 501(c)(3) organization operating in Puerto Rico.

EFFECTIVE DATE

The provision is effective for excise taxes collected on rum imported or brought into the United States after June 30, 1999 and before July 1, 2001.

### K. Delay Requirement That Registered Motor Fuels Terminals Offer Dyed Fuel as a Condition of Registration (sec. 110 of the bill and sec. 4101 of the Code)

PRESENT LAW

Excise taxes are imposed on highway motor fuels, including gasoline, diesel fuel, and kerosene, to finance the Highway Trust fund programs. Subject to limited exceptions, these taxes are imposed on all such fuels when they are removed from registered pipeline or barge terminal facilities, with any tax-exemptions being accomplished by means of refunds to consumers of the fuel.[9] One such exception allows removal of diesel fuel without payment of tax if the fuel is destined for a nontaxable use (e.g., use as heating oil) and is indelibly dyed.

Terminal facilities are not permitted to receive and store non-tax-paid motor fuels unless they are registered with the Internal Revenue Service. Under present law, a prerequisite to registration is that if the terminal offers for sale diesel fuel, it must offer both dyed and undyed diesel fuel. Similarly, if the terminal offers for sale kerosene, it must offer both dyed and undyed kerosene. This "dyed-fuel mandate" was enacted in 1997, to be effective on July 1, 1998. Subsequently, the effective date was delayed until July 1, 2000.

REASONS FOR CHANGE

When the present rules governing taxation of kerosene used as a highway motor fuel were enacted in 1997, the Congress was concerned that dyed kerosene (destined for nontaxable use) might not be available in markets where that fuel was commonly used (e.g., as heating oil). To ensure availability of untaxed kerosene for these uses, the Congress included a requirement that terminals offer both dyed and undyed kerosene and diesel fuel (if they offered the fuels for sale at all) as a condition of receiving untaxed fuels. Since that time, markets have provided dyed kerosene and diesel fuel for nontaxable uses in markets where there is a demand for such fuel

[9] Tax is imposed before that point if the motor fuel is transferred (other than in bulk) from a refinery or if the fuel is sold to an unregistered party while still held in the refinery or bulk distribution system (e.g., in a pipeline or terminal facility).

even in the absence of a statutory mandate for such fuels. The Committee found that a further delay in this registration requirement is appropriate to allow a more complete evaluation before a decision is made on whether to repeal or retain the mandate.

### EXPLANATION OF PROVISION

The provision delays the effective date of the dyed-fuel mandate for an additional six months, through December 31, 2000. No other changes are made to the present highway motor fuels excise tax rules.

### EFFECTIVE DATE

The provision is effective on the date of enactment.

## L. PRODUCTION CREDIT FOR FUEL PRODUCED BY CERTAIN COAL GASIFICATION FACILITIES (SEC. 111 OF THE BILL AND SEC. 29 OF THE CODE)

### PRESENT LAW

Certain fuels produced from "nonconventional sources" and sold to unrelated parties are eligible for an income tax credit equal to $3 (adjusted for inflation except in the case of tight sands gas) per barrel or Btu oil barrel equivalent (sec. 29). Qualified fuels must be produced in the United States. For 1999, the applicable credit rate is $6.23 per oil barrel equivalent.

Qualified fuels include:

(1) oil produced from shale and tar sands;

(2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and

(3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

Except with respect to fuel produced from coal and biomass facilities, the credit is available only for wells drilled or facilities placed in service before January 1, 1993. In the case of coal and biomass facilities, the credit is available for production from facilities placed in service before July 1, 1998, pursuant to a binding contract entered into before January 1, 1997.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (January 1, 2008 in the case of coal and biomass facilities subject to the later placed-in-service date described above).

### REASONS FOR CHANGE

The Committee believes that the credit provided under section 29 has been important to the development of environmentally friendly, domestic fuel sources. For example, the Committee observes that landfills produce methane as entombed garbage decays. Methane can be a valuable fuel but, if permitted to dissipate into the atmosphere, it may create environmental damage. The Committee believes that the section 29 credit has encouraged taxpayers to exploit this organic fuel source which can help produce needed electricity while providing environmental benefits for communities and the nation. The Committee concludes that extending the placed in service date will increase the further development of such energy sources.

EXPLANATION OF PROVISION

The provision extends the date by which certain facilities must be placed in service through June 30, 2000. This extension applies to the coal and biomass facilities which under present law were required to be paced in service before July 1, 1998. The January 1, 1997, binding contract date and the January 1, 2008, production period expiration date are not changed.

Credits allowed under the proposal that are attributable to periods before October 1, 2004, may not be taken into account in determining any amount required to be paid for any purpose under the Internal Revenue Code before October 1, 2004. Such credits will be available (without interest) on or after October 1, 2004, by filing an amended return, applying for an expedited refund, applying for an adjustment of estimated tax payments, or by other means allowed under the Internal Revenue Code.

EFFECTIVE DATE

The provision is effective on the date of enactment.

## TITLE II. REVENUE OFFSET PROVISIONS

### A. MODIFICATION OF INDIVIDUAL ESTIMATED TAX SAFE HARBOR (SEC. 201 OF THE BILL AND SEC. 6654 OF THE CODE)

PRESENT LAW

Under present law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. 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) 90 percent of the tax shown on the current year's return or (2) 100 percent of the prior year's tax. For taxpayers with a prior year's AGI above $150,000,[10] however, the rule that allows payment of 100 percent of prior year's tax is modified. Those taxpayers with AGI above $150,000 generally must make estimated payments based on either (1) 90 percent of the tax shown on the current year's return or (2) 110 percent of the prior year's tax.

For taxpayers with a prior year's AGI above $150,000, the prior year's tax safe harbor is modified for taxable years through 2002. For such taxpayers making estimated payments based on prior year's tax, payments must be made based on 105 percent of prior years tax for taxable years beginning in 1999, 106 percent of prior year's tax for taxable years beginning in 2000 and 2001, and 112 percent of prior year's tax for taxable years beginning in 2002.

REASONS FOR CHANGE

The Committee believes it is appropriate to modify the operation of these rules.

[10] $75,000 for married taxpayers filing separately.

EXPLANATION OF PROVISION

For taxpayers with a prior year's AGI above $150,000, the prior year's tax safe harbor is modified for taxable years 2000 and 2004. For such taxpayers making estimated payments based on prior year's tax, payments must be made based on 110.5 percent of prior year's tax for taxable years beginning in 2000, and payments must be based on 112 percent of prior year's tax for taxable years beginning in 2004.

EFFECTIVE DATE

For taxable years beginning after December 31, 1999, and before January 1, 2001, taxpayers with prior year's AGI above $150,000 who make estimated tax payments based on prior year's tax must do so based on 110.5 percent of the prior year's tax. For taxable years beginning after December 31, 2003, and before January 1, 2005, taxpayers with prior year's AGI above $150,000 who make estimated payments based on prior year's tax must do so based on 112 percent of prior year's tax.

## B. Modify Foreign Tax Credit Carryover Rules (sec. 202 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, 1999.

## C. Clarify the Tax Treatment of Income and Losses on Derivatives (sec. 203 of the bill and sec. 1221 of the Code)

### PRESENT LAW

Capital gain treatment applies to gain on the sale or exchange of a capital asset. Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, (4) certain copyrights (or similar property), and (5) U.S. government publications. Gain or loss on such assets generally is treated as ordinary, rather than capital, gain or loss. Certain other Code sections also treat gains or losses as ordinary. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary (sec. 475).

Under case law in a number of Federal courts prior to 1988, business hedges generally were treated as giving rise to ordinary, rather than capital, gain or loss. In 1988, the U.S. Supreme Court rejected this interpretation in *Arkansas Best* v. *Commissioner* which, relying on the statutory definition of a capital asset described above, held that a loss realized on a sale of stock was capital even though the stock was purchased for a business, rather than an investment, purpose.[11]

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

### REASONS FOR CHANGE

Absent an election by a commodities derivatives dealer to be treated the same as a dealer in securities under section 475, the character of the gains and losses with respect to commodities derivative financial instruments entered into by such a dealer may be unclear. The Committee is concerned that this uncertainty (i.e., the potential for capital treatment of the commodities derivatives financial instruments) could inhibit commodities derivatives dealers from entering into transactions with respect to commodities derivative financial instruments that qualify as "hedging transactions" within the meaning of the Treasury regulations under section 1221. The Committee believes that commodities derivatives financial instruments are integrally related to the ordinary course of the trade or business of commodities derivatives dealers and, therefore, such assets should be treated as ordinary assets.

The Committee further believes that ordinary character treatment is proper for business hedges with respect to ordinary prop-

[11] 485 U.S. 212 (1988).

erty. The Committee believes that the approach taken in the Treasury regulations with respect to the character of hedging transactions generally should be codified as an appropriate interpretation of present law. The Treasury regulations, however, model the definition of a hedging transaction after the present-law definition contained in section 1256, which generally requires that a hedging transaction "reduces" a taxpayer's risk. The Committee believes that a "risk management" standard better describes modern business hedging practices that should be accorded ordinary character treatment.[12]

In adopting a risk management standard, however, the Committee does not intend that speculative transactions or other transactions not entered into in the normal course of a taxpayer's trade or business should qualify for ordinary character treatment, and risk management should not be interpreted so broadly as to cover such transactions. In addition, to minimize whipsaw potential, the Committee believes that it is essential for hedging transactions to be properly identified by the taxpayer when the hedging transaction is entered into.

Finally, because hedging status under present law is dependent upon the ordinary character of the property being hedged, an issue arises with respect to hedges of certain supplies, sales of which could give rise to capital gain, but which are generally consumed in the ordinary course of a taxpayer's trade or business and that would give rise to ordinary deductions. For purposes of defining a hedging transaction, Treasury regulations treat such supplies as ordinary property.[13] The Committee believes that it is appropriate to confirm this treatment by specifying that such supplies are ordinary assets.

## EXPLANATION OF PROVISION

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

For this purpose, a commodities derivatives dealer is any person that regularly offers to enter into, assume, offset, assign or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business. A commodities derivative financial instrument means a contract or financial instrument with respect to commodities, the value or settlement price of which is calculated by reference to any combination of a

[12] The Committee believes that the Treasury regulations appropriately interpret "risk reduction" flexibly within the constraints of present law. For example, the regulations recognize that certain transactions that economically convert an interest rate or price from a fixed rate or price to a floating rate or price may qualify as hedging transactions (Treas. Reg. sec. 1.1221–2(c)(1)(ii)(B)). Similarly, the regulations provide hedging treatment for certain written call options, hedges of aggregate risk, "dynamic hedges" (under which a taxpayer can more frequently manage or adjust its exposure to identified risk), partial hedges, "recycled" hedges (using a position entered into to hedge one asset or liability to hedge another asset or liability), and hedges of aggregate risk (Treas. Reg. sec. 1.1221–2(c)). The Committee believes that (depending on the facts) treatment of such transactions as hedging transactions is appropriate and that it also is appropriate to modernize the definition of a hedging transaction by providing risk management as the standard.

[13] Treas. Reg. sec. 1.1221–2(c)(5)(ii).

fixed rate, price, or amount, or a variable rate, price, or amount, which is based on current, objectively determinable financial or economic information. This includes swaps, caps, floors, options, futures contracts, forward contracts, and similar financial instruments with respect to commodities. It does not include shares of stock in a corporation; a beneficial interest in a partnership or trust; a note, bond, debenture, or other evidence of indebtedness; or a contract to which section 1256 applies.

In defining a hedging transaction, the provision generally codifies the approach taken by the Treasury regulations, but modifies the rules. The "risk reduction" standard of the regulations is broadened to "risk management" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred). In addition, the Treasury Secretary is granted authority to treat transactions that manage other risks as hedging transactions. As under the present-law Treasury regulations, the transaction must be identified as a hedge of specified property. It is intended that this be the exclusive means through which the gains or losses with respect to a hedging transaction are treated as ordinary. Authority is provided for Treasury regulations that would address improperly identified or non-identified hedging transactions. The Treasury Secretary is also given authority to apply these rules to related parties.

#### EFFECTIVE DATE

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

### D. ADD CERTAIN VACCINES AGAINST STREPTOCOCCUS PNEUMONIAE TO THE LIST OF TAXABLE VACCINES (SEC. 204 OF THE BILL AND SECS. 4131 AND 4132 OF THE CODE)

#### PRESENT LAW

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

Amounts equal to net revenues from this excise tax are deposited in the Vaccine Injury Compensation Trust Fund ("Vaccine 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 and physicians. All persons immunized after September 30, 1988, with covered vaccines must pursue compensation under this Federal program before bringing civil tort actions under State law.

REASONS FOR CHANGE

Streptococcus pneumoniae (often referred to as pneumococcus) is a bacteria that can cause bacterial meningitis, a brain or spinal cord infection, bacteremia, a bloodstream infection, and otitis media (ear infection). The Committee understands that each year in the United States, pneumococcal disease accounts for an estimated 3,000 cases of bacterial meningitis, 50,000 cases of bacteremia, 500,000 cases of pneumonia, and 7 million cases of otitis media among all age groups. The Committee understands that, while there currently is a vaccine effective in preventing penumococcal diseases in adults, that vaccine, a polysaccaride vaccine, does not induce an adequate immune response in young children and therefore does not protect children against these diseases. The Committee further understands that the Food and Drug Administration's (the "FDA") is expected to approve a new, sugar protein conjugate vaccine against the disease and the Centers for Disease Control is expected to recommend this conjugate vaccine for routine inoculation of children. The Committee believes American children will benefit from wide use of this new vaccine. The Committee believes that, by including the new vaccine with those presently covered by the Vaccine Trust Fund, greater application of the vaccine will be promoted. The Committee, therefore, believes it is appropriate to add the conjugate vaccine against streptococcus pneumoniae to the list of taxable vaccines.

The Committee is aware that the Vaccine Trust Fund has a current cash-flow surplus in excess of $1.3 billion dollars.[14] However, the Committee thinks it is prudent to gather more detailed information on the operation of the Vaccine Injury Compensation Program and likely future claims to assess the adequacy of the Vaccine Trust Fund. Therefore, the Committee finds it appropriate to direct the Comptroller General of the United States to report on the operation and management of expenditures from the Vaccine Trust Fund and to advise the Committee on the adequacy of the Vaccine Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program.

EXPLANATION OF PROVISION

The bill adds any conjugate vaccine against streptococcus pneumoniae to the list of taxable vaccines. The bill also changes the effective date enacted in Public Law 105–277 and certain other conforming amendments to expenditure purposes to enable certain payments to be made from the Trust Fund.

In addition, the bill directs the General Accounting Office ('GAO") to report to the House Committee on Ways and Means and the Senate Committee on Finance on the operation and management of expenditures from the Vaccine Trust Fund and to advise the Committees on the adequacy of the Vaccine Trust Fund to meet future claims under the Federal Vaccine Injury Compensation Program.

Within its report, to the greatest extent possible, the Committee would like to see a thorough statistical report of the number of

[14] Joint Committee on Taxation, Schedule of Present Federal Excise Taxes (as of January 1, 1999) (JCS–2–99), March 29, 1999, p. 48.

claims submitted annually, the number of claims settled annually, and the value of settlements. The Committee would like to learn about the statistical distribution of settlements, including the mean and median values of settlements, and the extent to which the value of settlements varies with an injury attributed to an identifiable vaccine. The Committee also would like to learn about the settlement process, including a statistical distribution of the amount of time required from the initial filing of a claim to a final resolution.

The Code provides that certain administrative expanses may be charged to the Vaccine Trust Fund. The Committee intends that the GAO report include an analysis of the overhead and administrative expenses charged to the Vaccine Trust Fund.

The GAO is directed to report its findings to the House Committee on Ways and Means and the Senate Committee on Finance by January 31, 2000.

#### EFFECTIVE DATE

The provision is effective for vaccine purchases beginning on the day after the date on which the Centers for Disease Control make final recommendation for routine administration of conjugated streptococcus pneumonia vaccines to children. No floor stocks tax is to be collected for amounts held for sale on that date. For sales on or before the date on which the Centers for Disease Control make final recommendation for routine administration of conjugate streptococcus pneumonia vaccines to children for which delivery is made after such date, the delivery date is deemed to be the sale date. The addition of conjugate streptococcus pneumoniae vaccines to the list of taxable vaccines is contingent upon the inclusion in this legislation of the modifications to Public Law 105–277.

### E. EXPAND REPORTING OF CANCELLATION OF INDEBTEDNESS INCOME (SEC. 205 OF THE BILL AND SEC. 6050P OF THE CODE)

#### PRESENT LAW

Under section 61(a)(12), a taxpayer's gross income includes income from the discharge of indebtedness. Section 6050P requires "applicable entities" to file information returns with the Internal Revenue Serivce (IRS) regarding any discharge of indebtedness of $600 or more.

The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided. The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

"Applicable entities" include: (1) the Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (RTC), the National Credit Union Administration, and any successor or subunit of any of them; (2) any financial institution (as described in sec. 581 (relating to banks) or sec. 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. sec. 3701(a)(4)).

Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers is generally $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

### REASONS FOR CHANGE

The Committee believes that it is appropriate to treat discharges of indebtedness that are made by similar entities in a similar manner. Accordingly, the Committee believes that it is appropriate to extend the scope of this information reporting provision to include indebtedness discharged by any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies whether or not affiliated with financial institutions).

### EXPLANATION OF PROVISION

The bill requires information reporting on indebtedness discharged by any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies whether or not affiliated with financial institutions).

### EFFECTIVE DATE

The provision is effective with respect to discharges of indebtedness after December 31, 1999.

## F. Impose Limitation on Prefunding of Certain Employee Benefits (sec. 206 of the bill and secs. 419A and 4976 of the Code)

### PRESENT LAW

Under present law, contributions to a welfare benefit fund generally are deductible when paid, but only to the extent permitted under the rules of Code section 419 and 419A. The amount of an employer's deduction in any year for contributions to a welfare benefit fund cannot exceed the fund's qualified cost for the year. The term qualified cost means the sum of (1) the amount that would be deductible for benefits provided during the year if the employer paid them directly and was on the cash method of accounting, and (2) within limits, the amount of any addition to a qualified asset account for the year. A qualified asset account includes any account consisting of assets set aside for the payment of disability benefits, medical benefits, supplemental unemployment compensation or severance pay benefits, or life insurance benefits. The account limit for a quantified asset account for a taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits with respect to which the account is maintained and the administrative costs incurred with respect to those claims. Specific additional reserves are allowed for future provision of post-retirement medical and life insurance benefits.

The present-law deduction limits for contributions to welfare benefit funds do not apply in the case of certain 10-or-more employer plans. A plan is a 10-or-more employer plan if (1) more than one employer contributes to it, (2) no employer is normally required to contribute more than 10 percent of the total contributions under the plan by all employers, and (3) the plan does not maintain experience-rating arrangements with respect to individual employers.

If any portion of a welfare benefit fund reverts to the benefit of an employer that maintains the fund, an excise tax equal to 100 percent of the reversion is imposed on the employer.

### REASONS FOR CHANGE

The Committee understands that the exception to the welfare benefit fund deduction limits for 10-or-more employer plans has been utilized to fund retirement-type benefits and avoid the dollar limitations and other rules applicable to qualified retirement plans and the deduction timing rules applicable to nonqualified deferred compensation arrangements. Congress intended the exception to apply to a multiple employer welfare benefit plan under which the relationship of a participating employer to the plan is similar to the relationship of an insured to an insurer, and did not intend the exception to apply if the liability of any employer under the plan is determined on the basis of experience rating, which can create, in effect, a single-employer plan within a 10-or-more-employer arrangement. It is difficult to identify whether experience rating is occurring with respect to the provision of some benefits, such as severance pay and certain death benefits, because of the complexity of the benefit arrangements. Therefore, the Committee believes that it is appropriate to limit the benefits for which the 10-or-more employer exception is available.

### EXPLANATION OF PROVISION

Under the provision, the present-law exception to the deduction limit for 10-or-more employer plans is limited to plans that provide only medical benefits, disability benefits, and qualifying group-term life insurance benefits to plan beneficiaries. The Committee intends that a plan will not be treated as failing to provide only medical benefits, disability benefits, and qualifying group-term life insurance benefits to plan beneficiaries merely because the plan provides certain de minimis ancillary benefits in addition to medical, disability, and qualifying group-term life insurance benefits (e.g., accidental death and dismemberment insurance, group-term life insurance coverage for dependents and directors, business travel insurance, and 24-hour accident insurance). Such ancillary benefits are considered de minimis only if the total premiums for all such insurance coverages for the year do not exceed 2 percent of the total contributions to the plan for the year for all employers. Of course, any benefits provided are includable in income unless expressly excluded under a specific provision under the Code.

For purposes of this provision, qualifying group-term life insurance benefits do not include any arrangements that permit a plan beneficiary to directly or indirectly access all or part of the account value of any life insurance contract, whether through a policy loan, a partial or complete surrender of the policy, or otherwise. It is intended that qualifying group-term life insurance benefits do not include any arrangement whereby a plan beneficiary may receive a policy without a stated account value that has the potential to give rise to an account value whether through the exchange of such policy for another policy that would have an account value or otherwise.

The 10-or-more employer plan exception is no longer available with respect to plans that provide supplemental unemployment compensation, severance pay, or life insurance (other than qualifying group-term insurance) benefits. Thus, the generally applicable deduction limits (sections 419 and 419A) apply to plans providing these benefits.

In addition, if any portion of a welfare benefit fund attributable to contributions that are deductible pursuant to the 10-or-more employer exception (and earnings thereon) is used for a purpose other than for providing medical benefits, disability benefits, or qualifying group-term life insurance benefits to plan beneficiaries, such portion is treated as reverting to the benefit of the employers maintaining the fund and is subject to the imposition of the 100-percent excise tax.[15] Thus, for example, cash payments to employees upon termination of the fund, and loans or other distributions to the employee or employer, would be treated as giving rise to a reversion that is subject to the excise tax.

Under the provision, no inference is intended with respect to the validity of any 10-or-more employer arrangement under the provisions of present law.

#### EFFECTIVE DATE

The provision is effective with respect to contributions paid or accrued on or after June 9, 1999, in taxable years ending after such date.

### G. INCREASE ELECTIVE WITHHOLDING RATE FOR NONPERIODIC DISTRIBUTIONS FROM DEFERRED COMPENSATION PLANS (SEC. 207 OF THE BILL AND SEC. 3405 OF THE CODE)

#### PRESENT LAW

Present law provides that income tax withholding is required on designated distributions from employer compensation plans (whether or not such plans are tax qualified), individual retirement arrangements ("IRAs"), and commercial annuities unless the payee elects not to have withholding apply. A designated distribution does not include any payment (1) that is wages, (2) the portion of which it is reasonable to believe is not includable in gross income,

[15] For purposes of the provision, medical benefits, disability benefits, and qualifying group-term life insurance benefits include de minimis ancillary benefits as described above.

(3) that is subject to withholding of tax on nonresident aliens and foreign corporations (or would be subject to such withholding but for a tax treaty), or (4) that is a dividend paid on certain employer securities (as defined in sec. 404(k)(2)).

Tax is generally withheld on the taxable portion of any periodic payment as if the payment is wages to the payee. A periodic payment is a designated distribution that is an annuity or similar periodic payment.

In the case of a nonperiodic distribution, tax generally is withheld at a flat 10-percent rate unless the payee makes an election not to have withholding apply. A nonperiodic distribution is any distribution that is not a periodic distribution. Under current administrative rules, an individual receiving a nonperiodic distribution can designate an amount to be withheld in addition to the 10-percent otherwise required to be withheld.

Under present law, in the case of a nonperiodic distribution that is an eligible rollover distribution, tax is withheld at a 20-percent rate unless the payee elects to have the distribution rolled directly over to an eligible retirement plan (i.e., an IRA, a qualified plan (sec. 401(a)) that is a defined contribution plan permitting direct deposits of rollover contributions, or a qualified annuity plan (sec. 403(a)). In general, an eligible rollover distribution includes any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan or qualified annuity plan. An eligible rollover distribution does not include any distribution that is part of a series of substantially equal periodic payments made (1) for the life (or life expectancy) of the employee or for the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (2) over a specified period of 10 years or more. An eligible rollover distribution also does not include any distribution required under the minimum distribution rules of section 401(a)(9), hardship distributions from section 401(k) plans, or the portion of a distribution that is not includable in income. The payee of an eligible rollover distribution can only elect not to have withholding apply by making the direct rollover election.

### REASONS FOR CHANGE

The present-law 10-percent withholding rate is lower than the lowest income tax rate. Increasing the withholding rate to the lowest income tax rate makes it more likely that individuals who want withholding will have the correct amount of tax withheld.

### EXPLANATION OF PROVISION

Under the bill, the withholding rate for nonperiodic distributions would be increased from 10 percent to 15 percent. As under present law, unless the distribution is an eligible rollover distribution, the payee could elect not to have withholding apply. The bill does not modify the 20-percent withholding rate that applies to any distribution that is an eligible rollover distribution.

EFFECTIVE DATE

The provision is effective for distributions made after December 31, 2000.

## H. LIMIT CONVERSION OF CHARACTER OF INCOME FROM CONSTRUCTIVE OWNERSHIP TRANSACTIONS (SEC. 208 OF THE BILL AND NEW SEC. 1260 OF THE CODE)

PRESENT LAW

The maximum individual income tax rate on ordinary income and short-term capital gain is 39.6 percent, while the maximum individual income tax rate on long-term capital gain generally is 20 percent. Long-term capital gain means gain from the sale or exchange of a capital asset held more than one year. For this purpose, gain from the termination of a right with respect to property which would be a capital asset in the hands of the taxpayer is treated as capital gain.[16]

A pass-thru entity (such as partnership) generally is not subject to Federal income tax. Rather, each owner includes its share of a pass-thru entity's income, gain, loss, deduction or credit in its taxable income. Generally, the character of the item is determined at the entity level and flows through to the owners. Thus, for example, the treatment of an item of income by a partnership as ordinary income, short-term capital gain, or long-term capital gain retains its character when reported by each of the partners.

Investors may enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property that provides the investor with the same or similar economic benefits as owning the property directly but with potentially different tax consequences (as to the character and timing of any gain).

REASONS FOR CHANGE

The Committee is concerned with the use of derivative contracts by taxpayers in arrangements that are primarily designed to convert what otherwise would be ordinary income and short-term capital gain into long-term capital gain. Of particular concern are derivative contracts with respect to partnerships and other pass-thru entities. The use of such derivative contracts results in the taxpayer being taxed in a more favorable manner than had the taxpayer actually acquired an ownership interest in the entity. The current rules designed to prevent the conversion of ordinary income into capital gain (sec. 1258) only apply to transactions where the taxpayer's expected return is attributable solely to the time value of the taxpayer's net investment.

One example of a conversion transaction involving a derivative contract is when a taxpayer enters into an arrangement with a securities dealer[17] whereby the dealer agrees to pay the taxpayer any appreciation with respect to a notional investment in a hedge fund. In return, the taxpayer agrees to pay the securities dealer

[16] Section 1234A, as amended by the Taxpayer Relief Act of 1997.

[17] Assuming the securities dealer purchases the financial asset, the dealer would mark both the financial asset and the contractual arrangement to market under Code sec. 475, and the economic (and tax) consequences of the two positions would offset each other.

any depreciation in the value of the notional investment. The arrangement lasts for more than one year. The taxpayer is substantially in the same economic position as if he or she owned the interest in the hedge fund. However, the taxpayer may treat any appreciation resulting from the contractual arrangement as long-term capital gain. Moreover, any tax attributable to such gain is deferred until the arrangement is terminated.

EXPLANATION OF PROVISION

The provision limits the amount of long-term capital gain a taxpayer could recognize from certain derivative contracts ("constructive ownership transaction") with respect to certain financial assets. The amount of long-term capital gain is limited to the amount of such gain the taxpayer would have had if the taxpayer held the asset directly during the term of the derivative contract. Any gain in excess of this amount is treated as ordinary income. An interest charge is imposed on the amount of gain that is treated as ordinary income. The bill does not alter the tax treatment of the long-term capital gain that is not treated as ordinary income.

A taxpayer is treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to the financial asset, (2) enters into a forward contract to acquire the financial asset, (3) is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

The Committee anticipates that Treasury regulations, when issued, will provide specific standards for determining when other types of financial transactions, like those specified in the provision, have substantially the same effect of replicating the economic benefits of direct ownership of a financial asset without a significant change in the risk-reward profile with respect to the underlying transaction.[18]

A "financial asset" is defined as (1) any equity interest in a pass-thru entity, and (2) to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-thru entity. A "pass-thru entity" refers to (1) a regulated investment company, (2) a real estate investment trust, (3) a real estate mortgage investment conduit, (4) an S corporation, (5) a partnership, (6) a trust, (7) a common trust fund, (8) a passive foreign investment company, [19] (9) a foreign personal holding company, and (10) a foreign investment company.

The amount of recharacterized gain is calculated as the excess of the amount of long-term capital gain the taxpayer would have had absent this provision over the "net underlying long-term capital gain" attributable to the financial asset. The net underlying long-

[18] It is not expected that leverage in a constructive ownership transaction would change the risk-reward profile with respect to the underlying transaction.

[19] For this purpose, a passive foreign investment company includes an investment company that is also a controlled foreign corporation.

term capital gain is the amount of net capital gain the taxpayer would have realized if it had acquired the financial asset for its fair market value on the date the constructive ownership transaction was opened and sold the financial asset on the date the transaction was closed (only taking into account gains and losses that would have resulted from a deemed ownership of the financial asset).[20] The long-term capital gains rate on the net underlying long-term capital gain is determined by reference to the individual capital gains rates in section 1(h).

*Example 1:* On January 1, 2000, Taxpayer enters into a three-year notional principal contract (a constructive ownership transaction) with a securities dealer whereby, on the settlement date, the dealer agrees to pay Taxpayer the amount of any increase in the notional value of an interest in an investment partnership (the financial asset). After three years, the value of the notional principal contract increased by $200,000, of which $150,000 is attributable to ordinary income and net short-term capital gain ($50,000 is attributable to net long-term capital gains). The amount of the net underlying long-term capital gains is $50,000, and the amount of gain that is recharacterized as ordinary income is $150,000 (the excess of $200,000 of long-term gain over the $50,000 of net underlying long-term capital gain).

An interest charge is imposed on the underpayment of tax for each year that the constructive ownership transaction was open. The interest charge is the amount of interest that would be imposed under section 6601 had the recharacterized gain been included in the taxpayer's gross income during the term of the constructive ownership transaction. The recharacterized gain is treated as having accrued such that the gain in each successive year is equal to the gain in the prior year increased by a constant growth rate[21] during the term of the constructive ownership transaction.

*Example 2:* Same facts as in *example 1,* and assume the applicable Federal rate on December 31, 2002, is six percent. For purposes of calculating the interest charge, Taxpayer must allocate the $150,000 of recharacterized ordinary income to the three year-term of the constructive ownership transaction as follows: $47,116.47 is allocated to year 2000, $49,943.46 is allocated to year 2001, and $52,940.07 is allocated to year 2002.

A taxpayer is treated as holding a long position under a notional principal contract with respect to a financial asset if the person (1) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the financial asset for a specified period, and (2) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the financial asset. A forward contract is a contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

If the constructive ownership transaction is closed by reason of taking delivery of the underlying financial asset, the taxpayer is

[20] A taxpayer must establish the amount of the net underlying long-term capital gain with clear and convincing evidence; otherwise, the amount is deemed to be zero. To the extent that the economic positions of the taxpayer and the counterparty do not equally offset each other, the amount of the net underlying long-term capital gain may be difficult to establish.

[21] The accrual rate is the applicable Federal rate on the day the transaction closed.

treated as having sold the contract, option, or other position that is part of the transaction for its fair market value on the closing date. However, the amount of gain that is recognized as a result of having taken delivery is limited to the amount of gain that is treated as ordinary income by reason of this provision (with appropriate basis adjustments for such gain).

The provision does not apply to any constructive ownership transaction if all of the positions that are part of the transaction are marked to market under the Code or regulations. The provision also does not apply to transactions entered into by tax-exempt organizations and foreign taxpayers.

The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the provision, including to (1) permit taxpayers to mark to market constructive ownership transactions in lieu of the provision, and (2) exclude certain forward contracts that do not convey substantially all of the economic return with respect to a financial asset.

No inference is intended as to the proper treatment of a constructive ownership transaction entered into prior to the effective date of this provision.

#### EFFECTIVE DATE

The provision applies to transactions entered into on or after July 12, 1999. For this purpose, a contract, option or any other arrangement that is entered into or exercised on or after July 12, 1999 which extends or otherwise modifies the terms of a transaction entered into prior to such date is treated as a transaction entered into on or after July 12, 1999.

### I. Treatment of Excess Pension Assets Used for Retiree Health Benefits (sec. 209 of the bill, sec. 420 of the Code, and secs. 101, 403, and 408 of ERISA)

#### PRESENT LAW

Defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. Any assets that revert to the employer upon plan termination are includable in the gross income of the employer and subject to an excise tax. The excise tax rate, which may be as high as 50 percent of the reversion, varies depending upon whether or not the employer maintains a replacement plan or makes certain benefit increases. Upon plan termination, the accrues benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a section 401(h) account that is part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multiemployer plan) into a section 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includable in the gross income of the employer and are not subject to the excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, vesting requirements and minimum benefit requirements. Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the section 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) out of transferred assets. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

No deduction is allowed for (1) a qualified transfer of excess pension assets into a section 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer.

The minimum benefit requirement requires each group health plan under which applicable health benefits are provided to provide substantially the same level of applicable health benefits for the taxable year of the transfer and the following 4 taxable years. The level of benefits that must be maintained is based on benefits provided in the year immediately preceding the taxable year of the transfer. Applicable health benefits are health benefits or coverage that are provided to (1) retirees who, immediately before the transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan and (2) the spouses and dependents of such retirees.

The provision permitting a qualified transfer of excess pension assets to pay qualified current retiree health liabilities expires for taxable years beginning after December 31, 2000.[22]

[22] Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), provides that plan participants, the Secretaries of Treasury and the Department of Labor, the plan administrator, and each employee organization representing plan participants must be notified 60 days before a qualified transfer of excess assets to a retiree health benefits account occurs (ERISA sec. 103(e)). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA (ERISA sec. 408(b)(13)) or a prohibited reversion of assets to the employer (ERISA sec. 403(c)(1)). For purposes of these provisions, a qualified transfer is generally defined as a transfer pursuant to section 420 of the Internal Revenue Code, as in effect on January 1, 1995.

REASONS FOR CHANGE

The Committee believes that it is appropriate to provide a temporary extension of the present-law rule permitting an employer to make a qualified transfer of excess pension assets to a section 401(h) account for retiree health benefits as long as the security of employees' pension benefits is not threatened by the transfer. In light of the increasing cost of retiree health benefits, the Committee also believes that it is appropriate to replace the minimum benefit requirement applicable to qualified transfers under present law with a minimum cost requirement.

EXPLANATION OF PROVISION

The present-law provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under a section 401(h) account is extended through September 30, 2009. In addition, the present-law minimum benefit requirement is replaced by the minimum cost requirement that applied to qualified transfers before December 9, 1994, to section 401(h) accounts. Therefore, each group health plan or arrangement under which applicable health benefits are provided is required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following 4 taxable years. The minimum dollar level is the higher of the applicable employer costs for each of the 2 taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year is determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year.

EFFECTIVE DATE

The provision is effective with respect to qualified transfers of excess defined benefit pension plan assets to section 401(h) accounts after December 31, 2000, and before October 1, 2009. The modification of the minimum benefit requirement is effective with respect to transfers after the date of enactment. An employer is permitted to satisfy the minimum benefit requirement with respect to a qualified transfer that occurs after the date of enactment during the portion of the cost maintenance period of such transfer that overlaps the benefit maintenance period of a qualified transfer that occurs before the date of enactment. For example, suppose an employer (with a calendar year taxable year) made a qualified transfer in 1998. The minimum benefit requirement must be satisfied for calendar years 1998, 1999, 2000, 2001, and 2002. Suppose the employer also makes a qualified transfer in 2000. Then, the employer is permitted to satisfy the minimum benefit requirement in 2000, 2001, and 2002, and is required to satisfy the minimum cost requirement in 2003 and 2004.

## J. Modify Installment Method and Prohibit its Use by Accrual Method Taxpayers (sec. 210 of the bill and secs. 453 and 453A of the Code)

### PRESENT LAW

An accrual method taxpayer is generally required to recognize income when all the events have occurred that fix the right to the receipt of the income and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle of income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(l)(2)(B) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds[23] of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), or to dispositions where the sales price does not exceed $150,000.

An additional rule requires the payment of interest on the deferred tax that is attributable to most large installment sales.

### REASONS FOR CHANGE

The Committee believes that the installment method is inconsistent with the use of the accrual method of accounting and should not be allowed in situations where the disposition of property would otherwise be reported using the accrual method. The Committee is concerned that the continued use of the installment method in such situations would allow a deferral of gain that is inconsistent with the requirement of the accrual method that income be reported in the period it is earned, rather than the period it is received.

The Committee also believes that the installment method, where its use is appropriate, should not serve to defer the recognition of gain beyond the time when funds are received. Accordingly, the Committee believes that proceeds of a loan should be treated in the same manner as a payment on an installment obligation if the loan is dependent on the existence of the installment obligation, such as where the loan is secured by the installment obligation or can be satisfied by the delivery of the installment obligation.

[23] The net proceeds equal the gross loan proceeds less the direct expenses of obtaining the loan.

EXPLANATION OF PROVISION

*Prohibition on the use of the installment method for accrual method dispositions*

The provision generally prohibits the use of the installment method of accounting for dispositions of property that would otherwise be reported for Federal income tax purposes using an accrual method of accounting. The provision does not change present law regarding the availability of the installment method for dispositions of property used or produced in the trade or business of farming. The provision also does not change present law regarding the availability of the installment method for dispositions of timeshares or residential lots if the taxpayer elects to pay interest under section 453(l).

The provision does not change the ability of a cash method taxpayer to use the installment method. For example, a cash method individual owns all of the stock of a closely held accrual method corporation. This individual sells his stock for cash, a ten year note, and a percentage of the gross revenues of the company for the next ten years. The provision does not change the ability of this individual to use the installment method in reporting the gain on the sale of the stock.

*Modifications to the pledge rule*

The provision modifies the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer only recognizes gain as it receives the deferred payment. However, were the taxpayer to pledge the installment note as security for a loan, it would be required to treat the proceeds of such loan as a payment on the installment note, and recognize the appropriate amount of gain. Under the provision, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to "put" or repay the loan by transferring the installment note to the taxpayer's creditor. Other arrangements that have a similar effect would be treated in the same manner.

The modification of the pledge rule applies only to installment sales where the pledge rule of present law applies. Accordingly, the provision does not apply to (1) installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), (2) sales of property used or produced in the trade or business of farming, or (3) dispositions where the sales price does not exceed $150,000, since such sales are not subject to the pledge rule under present law.

EFFECTIVE DATE

The provision is effective for sales or other dispositions entered into on or after the date of enactment.

## K. Limitation on the Use of Non-Accrual Experience Method of Accounting (sec. 211 of the bill and sec. 448 of the Code)

### PRESENT LAW

An accrual method taxpayer generally must recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. An accrual method taxpayer may deduct the amount of any receivable that was previously included in income that becomes worthless during the year.

Accrual method taxpayers are not required to include in income amounts to be received for the performance of services which, on the basis of experience, will not be collected (the "non-accrual experience method"). The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

A cash method taxpayer is not required to include an amount in income until it is received. A taxpayer generally may not use the cash method if purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use an accrual method of accounting. In addition, corporations (and partnerships with corporate partners) generally may not use the cash method of accounting if their average annual gross receipts exceed $5 million. An exception to this $5 million rule is provided for qualified personal service corporations. A qualified personal service corporation is a corporation (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates or heirs. Qualified personal service corporations generally are allowed to use the cash method without regard to whether their average annual gross receipts exceed $5 million unless the purchase, production, or sale of merchandise is an income producing factor.

### REASONS FOR CHANGE

The Committee understands that the use of the non-accrual experience method provides the equivalent of a bad debt reserve, which generally is not available to taxpayers using the accrual method of accounting. The Committee believes that accrual method taxpayers should be treated similarly, unless there is a strong indication that different treatment is necessary to clearly reflect income or to address a particular competitive situation.

The Committee understands that accrual basis providers of qualified personal services (service in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting) compete on a regular basis with competitors using the cash method of accounting. The Committee believes that this competitive situation justifies the continued availability of the non-accrual experience method with respect to amounts due to be received for the performance of qualified personal services. The Committee believes that it is important to avoid the disparity of treatment between competing cash and accrual method providers of qualified personal services tat could result if the non-accrual experience method were eliminated with regard to amounts to be received for such services.

EXPLANATION OF PROVISION

The provision provides that the non-accrual experience method will be available only for amounts to be received for the performance of qualified personal services. Amounts to be received for the performance of all other services will be subject to the general rule regarding inclusion in income. Qualified personal services are personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. As under present law, the availability of the method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount.

EFFECTIVE DATE

The provision is effective for taxable years ending after the date of enactment. Any change in the taxpayer's method of accounting necessitated as a result of the proposal will be treated as a voluntary change initiated by the taxpayer with the consent of the Secretary of the Treasury. Any required section 481(a) adjustment will be taken into account over a period not to exceed four years under principles consistent with those in Rev. Proc. 98–60.[24]

## L. Denial of Charitable Contribution Deduction for Transfers Associated With Split-dollar Insurance Arrangements (sec. 212 of the bill and new sec. 501(c)(28) of the Code)

PRESENT LAW

Under present law, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer (secs. 170(b) and 170(e)). A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities (sec. 170(c)). The term "contribution or gift" is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent. If a taxpayer receives or expects to receive a quid pro quo in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return, provided the excess payment is made with the intention of making a gift.[25]

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property (sec. 170(f)(3)). In addition, no

[24] 1998–51 I.R.B. 16.

[25] *United States* v. *Americn Bar Endowment,* 477 U.S. 105 (1986). Treas. Reg. sec. 1.170A–1(h).

deduction is allowed for any contribution of $250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization that includes a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration, whole or part, for the taxpayer's contribution (sec. 170(f)(8)).

REASONS FOR CHANGE

The Committee is concerned about an abusive scheme[26] referred to as charitable split-dollar life insurance, and the provision is designed to stop the spread of this scheme. Under this scheme, taxpayers typically transfer money to a charity, which the charity then uses to pay premiums for cash value life insurance on the transferor or another person. The beneficiaries under the life insurance contract typically include members of the transferor's family (either directly or through a family trust or family partnership). Having passed the money through a charity, the transferor claims a charitable contribution deduction for money that is actually being used to benefit the transferor and his or her family. If the transferor or the transferor's family paid the premium directly, the payment would not be deductible. Although the charity eventually may get some of the benefit under the life insurance contract, it does not have unfettered use of the transferred funds.

The Committee is concerned that this type of transaction represents an abuse of the charitable contribution deduction. The Committee is also concerned that the charity often gets relatively little benefit from this type of scheme, and serves merely as a conduit or accommodation party, which the Committee does not view as appropriate for an organization with tax-exempt status. In substance, the charity receives a transfer of a partial interest in an insurance policy, for which no charitable contribution deduction is allowed. While there is no basis under present law for allowing a charitable contribution deduction in these circumstances, the Committee intends that the provision stop the marketing of these transactions immediately.

Therefore, the provision clarifies present law by specifically denying a charitable contribution deduction for a transfer to a charity if the charity directly or indirectly pays or paid any premium on a life insurance, annuity or endowment contract in connection with the transfer, and any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other noncharitable person chosen by the transferor. In addition, the provision clarifies present law by specifically denying the deduction for a charitable contribution if, in connection with a transfer to the charity, there is an understanding or expectation that any person with directly or indirectly pay any premium on any such contract.

The provision provides that certain persons are not treated as indirect beneficiaries, in certain cases in which a charitable organiza-

[26] "A Popular Tax Shelter for 'Angry Affluent' Prompts Ire of Others," Wall Street Journal, Jan. 22, 1999, p. A1; "U.S. Treasury Officials Investigating Charitable Split-Dollar Insurance Plan, "Wall Street Journal, Jan. 29, 1999, p. B5; "Brilliant Deduction?," The Chronicle of Philanthropy, Aug. 13, 1998, p. 24; "Charitable Reverse Split-Dollar; Bonanza or Booby Trap," Journal of Gift Planning, 2nd quarter 1998.

tion purchases an annuity contract to fund an obligation to pay a charitable gift annuity. The provision also provides that a person is not treated as an indirect beneficiary solely by reason of being a noncharitable recipient of an annuity or unitrust amount paid by a charitable remainder trust that holds a life insurance, annuity or endowment contract. The rationale for these rules is that the amount of the charitable contribution deduction is limited under present law to the value of the charitable organization's interest. Congress has previously enacted rules designed to prevent a charitable contribution deduction for the value of any personal benefit to the donor in these circumstances, and the Committee expects that the personal benefit to the donor is appropriately valued.

Further, the provision imposes an excise tax on the charity, equal to the amount of the premiums paid by the charity. Finally, the provision requires a charity to report annually to the Internal Revenue Service the amount of premiums subject to this excise tax and information about the beneficiaries under the contract.

EXPLANATION OF PROVISION

*Deduction denial*

The provision[27] restates present law to provide that no charitable contribution deduction is allowed for purposes of Federal tax, for a transfer to or for the use of an organization described in section 170(c) of the Internal Revenue Code, if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any "personal benefit contract' with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any "personal benefit contract" with respect to the transferor. It is intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

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

[27] The provision is similar to H.R. 630, introduced by Mr. Archer and Mr. Rangel (106th Cong., 1st Sess.).

ignated by the transferor) does not prevent it from being a personal benefit contract. The provision is not intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

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

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

Under the provision, an individual's family consists of the individual's grandparents, the grandparents of the individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

In the case of a charitable gift annuity obligation that is issued under the laws of a State that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that State, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that State, then the foregoing requirements (1) and (2) are treated as if they are met, provided that certain additional requirements are met. The additional requirements are that the State law requirement was in effect on February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide resident of the State at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and (as required by clause (iii) of subparagraph (D) of the provision) the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

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

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

*Excise tax*

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

*Reporting*

The provision requires that the charitable organization annually report the amount of premiums that is paid during the year and that is subject to the excise tax imposed under the provision, and the name and taxpayer identification number of each beneficiary under the life insurance, annuity or endowment contract to which the premiums relate, as well as other information required by the Secretary of the Treasury. For this purpose, it is intended that a beneficiary include any beneficiary under any side agreement to which the section 170(c) organization is a party (or of which it is otherwise aware). Penalties applicable to returns required under Code section 6033 apply to returns under this reporting requirement. Returns required under this provision are to be furnished at such time and in such manner as the Secretary shall by forms or regulations require.

*Regulations*

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

### EFFECTIVE DATE

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

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

## M. PREVENT DUPLICATION OR ACCELERATION OF LOSS THROUGH ASSUMPTION OF CERTAIN LIABILITIES (SEC. 213 OF THE BILL AND SEC. 358 OF THE CODE)

### PRESENT LAW

Generally, no gain or loss is recognized when one or more persons contribute property in exchange for stock and immediately after the exchange such person or persons control the corporation. However, the person may recognize gain to the extent it receives money or other property ("boot") as part of the exchange (sec. 351).

The assumption of liabilities by the controlled corporation generally is not treated as boot received by the transferor. One exception to this rule is when, "taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer * * * was a purpose to avoid Federal income tax on the exchange, or * * * if not such purpose, was not a bona fide business purpose" (sec. 357(b)). Another exception applies to the extent that the liabilities assumed exceed the total of the adjusted basis of the property transferred to the controlled corporation pursuant to the exchange (sec. 357(c)).

In general, the transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased in the amount of any gain recognized by the transferor on the exchange, and reduced by the amount of any money or property received (sec. 358). For this purpose, the assumption of a liability is treated as money received by the transferor.

Special rules apply in connection with the assumption of a liability that would give rise to a deduction. These liabilities are not taken into account in determining whether the transferor has gain on the exchange, and the transferor's basis in the stock of the controlled corporation is not reduced by the assumption of these liabilities. The Internet Revenue Service has ruled that the assumption of certain contingent liabilities by an accrual basis corporation is covered by this rule.[28]

REASONS FOR CHANGE

The Committee is concerned about a type of transaction in which taxpayers seek to accelerate, and potentially duplicate, deductions involving certain liabilities. As an example, assume a transferor corporation transfers assets with a fair market value basis) in exchange for preferred stock of the transferee corporation, plus the transferee's assumption of a contingent liability that is deductible in the future. The transferor claims a basis for the stock equal to the basis of the transferred assets. However, the value of the stock is reduced by the amount of the liability, creating a potential loss. The transferor may then attempt to accelerate the deduction that would be attributable to the liability by selling or exchanging the stock. Furthermore, the transferee might take the position that it is entitled to deduct the payments on the liability, effectively duplicating the deduction attributable to the liability.

The conference report to the Taxpayer Refund and Relief Act of 1999 contained a provision that would have amended the "principal purpose" aspect of the anti-abuse rule. The Committee believes that a different approach is more appropriate; one that eliminates any loss on the sale of stock attributable to such liabilities.

EXPLANATION OF PROVISION

The provision provides that if the basis of stock received by a transferor as part of a tax-free exchange with a controlled corporation exceeds its fair market value (without regard to this proposal), then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such property, and (2) did not otherwise reduce the transferor's basis of the stock by reason of the assumption. The provision does not apply where the trade or business giving rise to the liability is transferred to the corporation as part of the exchange. Nor does the provision change the tax treatment with respect to the transferee corporation. For this purpose, the term "liability" includes any obligation to make payment, without regard to whether the obligation is fixed or contingent or otherwise taken into account under the Code. The Secretary of the Treasury shall prescribe such regulations as may be necessary to carry out the purposes of this provision.

The application of the provision is illustrated in the following example: Assume a taxpayer transfers assets with an adjusted basis and fair market value of $100 to its wholly-owned corporation and the corporation assumes $40 of liabilities (the payment of which would give rise to a deduction). Thus, the value of the stock received by the transferor is $60. Under present law, the basis of the stock would be $100. The provision requires that the basis of the stock be reduced to $60 (i.e., a reduction of $40). The basis reduc-

[28] Rev. Rul. 95–74, 1995–2 C.B. 36.

tion would not be required if the transferred assets consisted of the trade or business with respect to which the liability arose.

The Secretary of the Treasury is directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the provision) in transactions involving partnerships.

### EFFECTIVE DATE

The provision is effective for assumptions of liabilities on or after October 19, 1999. Except as provided by the Secretary of the Treasury, the rules addressing transactions involving partnerships would be effective for assumptions of liabilities on or after October 19, 1999.

## N. Require Consistent Treatment and Provide Basis Allocation Rules for Transfers of Intangibles in Certain Nonrecognition Transactions (sec. 214 of the bill and secs. 351 and 721 of the Code)

### PRESENT LAW

Generally, no gain or loss is recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and, immediately after the exchange such person or persons are in control of the corporation. Similarly, no gain or loss is recognized in the case of a contribution of property in exchange for a partnership interest. Neither the Internal Revenue Code nor the regulations provide the meaning of the requirement that a person “transfer property” in exchange for stock (or a partnership interest). The Internal Revenue Service interprets the requirement consistent with the “sale or other disposition of property” language in the context of a taxable disposition of property. See, e.g., Rev. Rul. 69–156, 1969–1 tax-free exchange and stock received will be treated as payments for the use of property rather than for the property itself. These amounts are characterized as ordinary income. However, the Claims Court has rejected the Service’s position and held that the transfer of a nonexclusive license to use a patent (or any transfer of “something of value”) could be a “transfer” of “property” for purposes of the nonrecognition provision. See *E.I. DuPont de Nemours & Co.* v. *U.S.,* 471 F.2d 1211 (Ct. Cl. 1973).

### REASONS FOR CHANGE

The Committee is concerned that the uncertainty of present law may encourage transferors and transferees to attempt to take inconsistent reporting positions that may have the effect of “whipsawing” the government. Also, the Committee believes that clear basis allocation rules should be provided.

### EXPLANATION OF PROVISION

The provision treats a transfer of an interest in intangible property constituting less than all of the substantial rights of the transferor in the property as a transfer of property for purposes of the nonrecognition provisions regarding transfers of property to controlled corporations and partnerships. In the case of a transfer of less than all of the substantial rights, the transferor is required to allocate the basis of the intangible between the retained rights and the transferred rights based upon their respective fair market values.

No inference is intended as to the treatment of these or similar transactions prior to the effective date.

#### EFFECTIVE DATE

The provision is effective for transfers on or after the date of enactment.

### O. DISTRIBUTIONS BY A PARTNERSHIP TO A CORPORATE PARTNER OF STOCK IN ANOTHER CORPORATION (SEC. 215 OF THE BILL AND SEC. 732 OF THE CODE)

#### PRESENT LAW

Present law generally provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80 percent of the stock (by vote and value) (sec. 332). The basis of property received by a corporate distributee in the distribution in complete liquidation of the 80-percent-owned subsidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (sec. 334(b)).

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 before 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).

If corporate stock is distributed by a partnership to a corporate partner with a low basis in its partnership interest, the basis of the stock is reduced in the hands of the partner so that the stock basis equals the distributee partner's adjusted basis in its partnership interest. No comparable reduction is made in the basis of the corporation's assets, however. The effect of reducing the stock basis can be negated by a subsequent liquidation of the corporation under section 332.[29]

REASONS FOR CHANGE

The Committee is concerned that the downward adjustment to the basis of property distributed by a partnership may be nullified if the distributed property is corporate stock. The distributed corporation can be liquidated by the corporate partner, so that the stock basis adjustment has no effect. Similarly, if the corporations file a consolidated return, their taxable income may be computed without reference to the downward adjustment to the basis of the stock.These results can occur either if the partnership has contributed property to the distributed corporation, or if the property was held by the corporation before the distribution. Therefore, the provision requires a basis reduction to the property of the distributed corporation.

EXPLANATION OF PROVISION

*In general*

The provision provides for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner. The reduction applies if, after the distribution, the corporate partner controls the distributed corporation.

*Amount of the basis reduction*

Under the provision, the amount of the reduction in basis of property of the distributed corporation generally equals the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution, over (2) the corporate partner's basis in that stock immediately after the distribution.

The provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation. Thus, for example, if the distributed corporation has cash of $300 and other property with a basis of $600 and the corporate partner's basis in the stock of the distributed corporation is $400, then the amount of the basis reduction could not exceed $500 (i.e., ($300+$600)−$400=$500).

Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation could not be reduced below zero under the provision, even though the total amount of the basis reduction would otherwise be greater.

The provision provides that the corporate partner recognizes long-term capital gain to the extent the amount of the basis reduc-

[29] In a similar situation involving the purchase of stock of a subsidiary corporation as replacement property following an involuntary conversion, the Code generally requires the basis of the assets held by the subsidiary to be reduced to the extent that the basis of the stock in the replacement corporation itself is reduced (sec. 1033).

tion exceeds the basis of the property (other than money) of the distributed corporation. In addition, the corporate partner's adjusted basis in the stock of the distribution is increased in the same amount. For example, if the amount of the basis reduction were $400, and the distributed corporation has money of $200 and other property with an adjusted basis of $300, then the corporate partner would recognize a $100 capital gain under the provision. The corporate partner's basis in the stock of the distributed corporation is also increased by $100 in this example, under the provision.

The basis reduction is allocated among assets of the controlled corporation in accordance with the rules provided under section 732(c).

*Partnership distributions resulting in control*

The basis reduction generally applies with respect to a partnership distribution of stock if the corporate partner controls the distributed corporation immediately after the distribution or at any time thereafter. For this purpose, the term control means ownership of stock meeting the requirements of section 1504(a)(2) (generally, an 80-percent vote and value requirement).

The provision applies to reduce the basis of any property held by the distributed corporation immediately after the distribution, or, if the corporate partner does not control the distributed corporation at that time, then at the time the corporate partner first has such control. The provision does not apply to any distribution if the corporate partner does not have control of the distributed corporation immediately after the distribution and establishes that the distribution was not part of a plan or arrangement to acquire control.

For purposes of the provision, if a corporation acquires (other than in a distribution from a partnership) stock the basis of which is determined (by reason of being distributed from a partnership) in whole or in part by reference to section 732(a)(2) or (b), then the corporation is treated as receiving a distribution of stock from a partnership. For example, if a partnership distributes property other than stock (such as real estate) to a corporate partner, and that corporate partner contributes the real estate to another corporation in a section 351 transaction, then the stock received in the section 351 transaction is not treated as distributed by a partnership, and the basis reduction under this provision does not apply. As another example, if a partnership distributes stock to two corporate partners, neither of which have control of the distributed corporation, and the two corporate partners merge and the survivor obtains control of the distributed corporation, the stock of the distributed corporation that is acquired as a result of the merger is treated as received in a partnership distribution; the basis reduction rule of the provision applies.

In the case of tiered corporations, a special rule provides that if the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, then the provision is applied to reduce the basis of the property of that controlled corporation. The provision is also reapplied to any property of any controlled corporation that is stock in a corporation that it controls. Thus, for example, if stock of a controlled corporation is distributed to a corporate partner, and the controlled corporation has a subsidiary, the amount of the basis reduction allocable to stock of the subsidiary is applied again to reduce the basis of the assets of the subsidiary, under the special rule.

The provision also provides for regulations, including regulations to avoid double counting and to prevent the abuse of the purposes of the provision. It is intended that regulations prevent the avoidance of the purposes of the provision through the use of tiered partnerships.

### EFFECTIVE DATE

The provision is effective for distributions made after July 14, 1999, except that in the case of a corporation that is a partner in a partnership on July 14, 1999, the provision is effective for distributions by that partnership to the corporation after the date of enactment.

## P. PROHIBITED ALLOCATIONS OF STOCK IN AN S CORPORATION ESOP (SEC. 216 OF THE BILL AND SECS. 409(n) AND 4979A OF THE CODE)

The Small Business Job Protection Act of 1996 allowed qualified retirement plan trusts described in section 401(a) to own stock in an S corporation. That Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includable in full in the trust's unrelated business taxable income ("UBTI").

The Tax Relief Act of 1997 repealed the provision treating items of income or loss of an S corporation as UBTI in the case of an employee stock ownership plan ("ESOP"). Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation.

Present law provides a deferral of income on the sales of certain employer securities to an ESOP (sec. 1042). A 50-percent excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP in a transaction to which section 1042 applies. In addition, such allocations are currently includable in the gross income of the individual receiving the prohibited allocation.

### REASONS FOR CHANGE

In enacting the provision relating to S corporation ESOPs in 1997, the Congress was concerned that the prior-law rule imposed double taxation on such ESOPs and ESOP participants. The Congress believed that such a result was inappropriate. Since the enactment of the 1997 Act, however, the Committee has become aware that the present-law rules allow inappropriate deferral and possibly tax avoidance in some cases.

The Committee believes that S corporations should be able to establish ESOPs. The Committee does not believe, however, that ESOPs should be used by S corporation owners to obtain inappropriate tax deferral or avoidance. The Committee is particularly concerned about S corporations owned by a small group of individuals who may attempt to use present law to defer or avoid income taxes. The Committee believes that the provision in the bill strikes an appropriate balance between the policies of fostering employee ownership in S corporations and ensuring the proper application of the Federal income tax laws.

EXPLANATION OF PROVISION

*In general*

Under the bill, if there is a nonallocation year with respect to an ESOP maintained by an S corporation: (1) the amount allocated in a prohibited allocation to an individual who is a disqualified person is treated as distributed to such individual (i.e., the value of the prohibited allocation is includable in the gross income of the individual receiving the prohibited allocation); (2) an excise tax is imposed on the S corporation equal to 50 percent of the amount involved in a prohibited allocation; and (3) an excise tax is imposed on the S corporation with respect to any synthetic equity owned by a disqualified person.[30]

*Definition of nonallocation year*

A nonallocation year means any plan year of an ESOP holding shares in an S corporation if, at any time during the plan year, disqualified persons own at least 50 percent of the number of outstanding shares of the S corporation.

A person is a disqualified person if the person is either (1) a member of a "deemed 20-percent shareholder group" or (2) a "deemed 10-percent shareholder." A person is a member of a "deemed 20-percent shareholder group" if the number of deemed-owned shares of the person and his or her family members is at least 20 percent of the number of deemed-owned shares of stock in the S corporation.[31] A person is a deemed 10-percent shareholder if the person is not a member of a deemed 20-percent shareholder group and the number of the person's deemed-owned shares is at least 10 percent of the number of deemed-owned shares of stock of the corporation.

In general, "deemed-owned shares" mean: (1) stock allocated to the account of an individual under the ESOP, and (2) an individual's share of unallocated stock held by the ESOP. An individual's share of unallocated stock held by an ESOP is determined in the same manner as the most recent allocation of contributions under the terms of the plan.

For purposes of determining whether there is a nonallocation year, ownership of stock is generally attributed under the rules of section 318,[32] except that (1) the family attribution rules are modified to include certain other family members, as described below, (2) option attribution does not apply (but instead special rules relating to synthetic equity describes below apply), and (3) "deemed-owned shares" held by the ESOP are treated as held by the individual with respect to whom they are deemed owned.

Under the bill, family members of an individual include (1) the spouse[33] of the individual, (2) an ancestor or lineal descendant of the individual or his or her spouse, (3) a sibling of the individual (or the individual's spouse) and and linear descendant of the broth-

[30] A prohibited allocation does not result in disqualification of the plan.

[31] A family member of a member of a "deemed 20-percent shareholder group" with deemed owned shares is also treated as a disqualified person.

[32] These attribution rules also apply to stock treated as owned by reason of the ownership of synthetic equity.

[33] As under section 318, an individual's spouse is not treated as a member of the individual's family if the spouses are legally separated.

er or sister, and (4) the spouse of any person described in (2) or (3).

The bill contains special rules applicable to synthetic equity interests. Except to the extent provided in regulations, the stock on which a synthetic equity interest is based is treated as outstanding stock of the S corporation and as deemed-owned shares of the person holding the synthetic equity interest if such treatment would result in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Thus, for example, disqualified persons for a year include those individuals who are disqualified persons under the general rule (i.e., treating only those shares held by the ESOP as deemed-owned shares) and those individuals who are disqualified individuals if synthetic equity interests are treated as deemed-owned shares.

"Synthetic equity" means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.[34] Ownership of synthetic equity is attributed in the same manner as stock is attributed under the provision (as described above). In addition, ownership of synthetic equity is attributed under the rules of section 318(a)(2) and (3) in the same manner as stock.

*Definition of prohibited allocation*

An ESOP of an S corporation is required to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) S corporation stock may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the S corporation) for the benefit of a disqualifed person. A "prohibited allocation" refers to violation of this provision. A prohibited allocation occurs, for example, if income on S corporation stock held by an ESOP were allocated to the account of an individual who is a disqualified person.

*Application of excise tax*

In the case of a prohibited allocation, the S corporation is liable for an excise tax equal to 50 percent of the amount of the allocation. For example, if S corporation stock were allocated in a prohibited allocation, the excise tax would be equal to 50 percent of the fair market value of such stock.

A special rule applies in the case of the first nonallocation year, regardless of whether there is a prohibited allocation. In that year, the excise tax also applies to the fair market value of the deemed-owned shares of any disqualified person held by the ESOP, even though those shares are not allocated to the disqualified person in that year.

As mentioned above, the S corporation is also liable for an excise tax with respect to any synthetic equity interest owned by any dis-

[34] The provisions relating to synthetic equity do not modify the rules relating to S corporations, e.g., the circumstances in which options or similar interests are treated as creating a second class of stock.

qualified person in a nonallocation year. The excise tax is 50 percent of the value of the shares on which synthetic equity is based.

*Treasury regulations*

The Treasury Department is given the authority to prescribe such regulations as may be necessary to carry out the purposes of the provision.

EFFECTIVE DATE

The provision generally is effective with respect to years beginning after December 31, 2000. In the case of an ESOP established after July 14, 1999, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the provision is effective with respect to plan years ending after July 14, 1999.

## Q. TREATMENT OF REAL ESTATE INVESTMENT TRUSTS (REITS)

### 1. Provisions relating to REITs (sec. 221–226, 231, 241, 251, and 261 of the bill and secs. 852, 856, and 857 of the Code)

PRESENT LAW

A real estate investment trust ("REIT") is an entity that receives most of its income from passive real-estate related investments and that essentially receives pass-through treatment for income that is distributed to shareholders. If an electing entity meets the requirements of 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. In general, a REIT must derive its income from passive sources and not engage in any active trade or business.

A REIT must satisfy a number of tests on a year by year basis that relate to the entity's (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income. Under the source-of-income tests, at least 95 percent of its gross income generally must be derived from rents from real property, dividends, interest, and certain other passive sources (the "95 percent test"). In addition, at least 75 percent of its gross income generally must be from real estate sources, including rents from real property and interest on mortgages secured by real property. For purposes of the 95 and 75 percent tests, qualified income includes amounts received from certain "foreclosure property," treated as such for 3 years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or on indebtness which such property secured.

In general, for purposes of the 95 percent and 75 percent tests, rents from real property do not include amounts for services to tenants or for managing or operating real property. However, there are some exceptions. Qualified rents include amounts received for services that are "customarily furnished or rendered" in connection with the rental or real property, so long as the services are furnished through an independent contractor from whom the REIT does not derive any income. Amounts received for services that are not "customarily furnished or rendered" are not qualified rents.

An independent contractor is defined as a person who does not own, directly or indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT. In addition, a REIT cannot derive any income from an independent contractor.

Rents for certain personal property leased in connection with real property are treated as rents from real property if the adjusted basis of the personal property does not exceed 15 percent of the aggregate adjusted bases of the real and the personal property.

Rents from real property do not include amounts received from any corporation if the REIT owns 10 percent or more of the voting power or of the total number of shares of all classes of stock of such corporation. Similarly, in the case of other entities, rents are not qualified if the REIT owns 10 percent of more in the assets or net profits of such person.

At the close of each quarter of the taxable year, at least 75 percent of the value of total REIT assets must be represented by real estate assets, cash and cash items, and Government securities. Also, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25 percent of the value of REIT assets. In addition, it cannot own securities of any one issuer representing more than 5 percent of the total value of REIT assets or more than 10 percent of the voting securities of any corporate issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940.[35]

Under an exception to the ownership rule, a REIT is permitted to have a wholly owned subsidiary corporation, but the assets and items of income and deduction of such corporation are treated as those of the REIT, and thus can affect the qualification of the REIT under the income and asset tests.

A REIT generally is required to distribute 95 percent of its income before the end of its taxable year, as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies ("RICS") that requires distribution of 90 percent of income. Both REITS and RICs can make certain "deficiency dividends" after the close of the taxable year, and have these treated as made before the end of the year. The regulations applicable to REITS state that a distribution will be treated as a "deficiency dividend" (and, thus, as made before the end of the prior taxable year) only to the extent the earnings and profits for that year exceed the amount of distributions actually made during the taxable year.[36]

A REIT that has been or has combined with a C corporation[37] will be disqualified if, as of the end of its taxable year, it has accumulated earnings and profits from a non-REIT year. A similar rule

[35] 15 U.S.C. 80a–1 and following. See Code section 856(c)(5)(F).

[36] Treas. Reg. sec. 1.858–1(b)(2).

[37] A "C corporation" is a corporation that is subject to taxation under the rules of subchapter C of the Internal Revenue Code, which generally provides for a corporate level tax on corporate income. Thus, a C corporation is not a pass-through entity. Earnings and profits of a C corporation, when distributed to shareholders, are taxed to the shareholders as dividends.

applies to regulated investment companies ("RICs"). In the case of a REIT, any distribution made in order to comply with this requirement is treated as being first from pre-REIT accumulated earnings and profits. RICs do not have a similar ordering rule.

In the case of a RIC, any distribution made within a specific period after determination that the investment company did not qualify as a RIC for the taxable year will be treated as applying to the RIC for the non-RIC year, "for purposes of applying [the earnings and profits rule that forbids a RIC to have non-RIC earnings and profits] to subsequent taxable years". The REIT rules do not specify any particular separate treatment of distributions made after the end of the taxable year for purposes of the earnings and profits rule. Treasury regulations under the REIT provisions state that "distribution procedures similar to those * * * for regulated investment companies apply to non-REIT earnings and profits of a real estate investment trust."[38]

REASONS FOR CHANGE

The Committee is concerned that under present law, disqualified income of a REIT may be avoided through transactions with entities that are engaged in activities that produce disqualified income but that are effectively owned by the REIT. For example, a REIT may invest in an entity in which it owns virtually all the value (e.g., through preferred stock) even though it owns only a small amount of the vote. The remainder of the voting power might be held by persons related to the REIT such as its officers, directors, or employees. The REIT might effectively be the beneficiary of virtually all the earnings of the entity, through its preferred stock ownership. Also, the REIT might hold significant debt in the entity, and receive significant interest income that reduces the entity's taxable income (subject to corporate level tax if the entity is a C corporation) while producing permissible income to the REIT.

Similarly, if the entity is a partnership engaged in activities that would generate nonqualified income for the REIT if done directly, the REIT might use a significant debt investment in the partnership combined with a small equity interest, to reduce the amount of nonqualified income it would report from the partnership through its partnership interest, while still receiving a significant income stream through the debt.

As a result of these concerns, the Committee believes that a 10-percent value, as well as a 10-percent vote test, generally is appropriate to test the permitted relationship of a REIT to the entities in which it invests.

The Committee believes, however, that certain types of activities that relate to the REIT's real estate investments should be permitted to be performed under the control of the REIT, through the establishment of a "taxable REIT subsidiary" where there are rules which limit the amount of the subsidiary's income that can be reduced through transactions with the REIT. A limit on the amount of REIT asset value that can be represented by investment in such subsidiaries is also desirable. In addition, the Committee believes it is desirable to obtain information regarding the extent of use of

[38] Treas. Reg. sec. 1.857–11(c).

the new taxable REIT subsidiaries and the amount of corporate Federal income tax that such subsidiaries are paying. One type of activity is the provision of tenant services that the REIT wishes to provide in order to remain competitive that might not be considered customary because they are relatively new or "cutting-edge". The Committee believes that provision of tenant services by taxable REIT subsidiaries will simplify such rental operations since uncertainty whether a particular service provided by a subsidiary is "customary" will not affect the parent's qualification as a REIT. Another type of activity that the Committee believes appropriate for a subsidiary is management and operation of the real estate in which a REIT has developed expertise with respect to its own properties that it also would like to provide to third parties.

The Committee believes that allowing operation of health care facilities directly by a REIT for a limited period of time is appropriate to assure continuous provision of health care services where the facilities are acquired by the REIT upon termination of a lease (as upon foreclosure) where there may not be enough time to obtain a new independent provider of such health care services.

Finally, the Committee believes that a number of other simplifying changes are desirable, including simplifying the determination whether a publicly traded entity is an independent contractor and modifying and conforming certain RIC and REIT distribution rules.

EXPLANATION OF PROVISION

*Investment limitations and taxable REIT subsidiaries*

*General rule.*—Under the provision, a REIT generally cannot own more than 10 percent of the total value of securities of a single issue, in addition to the present law that a REIT cannot own more than 10 percent of the outstanding voting securities of a single issuer. In addition, no more than 20 percent of the value of a REIT's assets can be represented by securities of the taxable REIT subsidiaries that are permitted under the bill.

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

*Exception for taxable REIT subsidiaries.*—An exception to the limitations on ownership of securities of a single issuer applies in the case of a "taxable REIT subsidiary" that meets certain requirements. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT or a qualified REIT subsidiary under section 856(i) that does not properly elect with the REIT to be a taxable REIT subsidiary) of which a taxable REIT subsidiary owns, directly or indirectly, more than 35 percent of the vote or value is automatically treated as a taxable REIT subsidiary.

Securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries may not exceed 20 percent of the total value of a REIT's assets.

A taxable REIT subsidiary can engage in certain business activities that under present law could disqualify the REIT because, but for the proposal, the taxable REIT subsidiary's activities and relationship with the REIT could prevent certain income from qualifying as rents from real property. Specifically, the subsidiary can provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and can manage or operate properties, generally for third parties, without causing amounts received or accrued directly or indirectly by REIT for such activities to fail to be treated as rents from real property. However, rents paid to a REIT are not generally qualified rents if the REIT owns more than 10 percent of the value (as well as of the vote) of a corporation paying the rents. The only exceptions are for rents that are paid by taxable REIT subsidiaries and that also meet a limited rental exception (where 90 percent of space is leased to third parties at comparable rents) and an exception for rents from certain lodging facilities (operated by an independent contractor).

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

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

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

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

If any amount of interest, rent, or other deductions of the taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arm's length ("redetermined" items), an excise tax of 100 percent is imposed on the portion that was excessive. "Safe harbors" are provided for certain rental payments where (1) the amounts are de minimis, (2) there is specified evidence that charges to unrelated parties are substantially comparable, (3) certain charges for services from the taxable REIT subsidiary are separately stated, or (4) the subsidiary's gross income from the service is not less than 150 percent of the subsidiary's direct cost in furnishing the service.

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

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

*Health care REITs*

The provision permits a REIT to own and operate a health care facility for at least two years, and treat it as permitted "foreclosure" property, if the facility is acquired by the termination or expiration of a lease of the property. Extensions of the 2 year period can be granted.

*Conformity with regulated investment company rules*

Under the provision, the REIT distribution requirements are modified to conform to the rules for regulated investment companies. Specifically, a REIT is required to distribute only 90 percent, rather than 95 percent, of its income.

*Definition of independent contractor*

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

*Modification of earnings and profits rules for RICs and REITs*

The rule allowing a RIC to make a distribution after a determination that it had failed RIC status, and thus meet the requirement of no non-RIC earnings and profits in subsequent years, is modified to clarify that, when the sole reason for the determination is that the RIC had no-RIC earnings and profits in the initial year (i.e., because it was determined not to have distributed all C corporation earnings and profits), the procedure would apply to permit

RIC qualification in the initial year to which such determination applied, in addition to subsequent years.

The RIC earnings and profits rules are also modified to provide an ordering rule similar to the REIT rule, treating a distribution to meet the requirements of no non-RIC earnings and profits as coming first from the earliest earnings and profits accumulated in any year for which the RIC did not qualify as a RIC. In addition, the REIT deficiency dividend rules are modified to apply the same earnings and profits ordering rule to such dividends as other REIT dividends.

*Provision regarding rental income from certain personal property*

The provision modifies the present law rule that permits certain rents from personal property to be treated as real estate rental income if such personal property does not exceed 15 percent of the aggregate of real and personal property. The provision replaces the present law comparison of the adjusted bases of properties with a comparison based on fair market values.

### EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2000. The provision with respect to modification of earnings and profits rules is effective for distributions after December 31, 2000.

In the case of the provisions relating to permitted ownership of securities of an issuer, special transition rules apply. The new rules forbidding a REIT to own more than 10 percent of the value of securities of a single issuer do not apply to a REIT with respect to securities held directly or indirectly by such REIT on July 12, 1999, or acquired pursuant to the terms of written binding contract in effect on that date and at all times thereafter until the acquisition. Also, securities received in a tax-free exchange or reorganization, with respect to or in exchange for such grandfathered securities would be grandfathered. The grandfathering of such securities ceases to apply if the REIT acquires additional securities of that issuer after that date, other than pursuant to a binding contract in effect on that date and at all times thereafter, or in a reorganization with another corporation the securities of which are grandfathered.

This transition also ceases to apply to securities of a corporation as of the first day of July 12, 1999 on which such corporation engages in a substantial new line of business, or acquires any substantial asset, other than pursuant to a binding contract in effect on such date and at all times thereafter, or in a reorganization or transaction in which gain or loss is not recognized by reason of section 1031 or 1033 of the Code. If a corporation makes an election to become a taxable REIT subsidiary, effective before January 1, 2004 and at a time when the REIT's ownership is grandfathered under these rules, the election is treated as a reorganization under section 368(a)(1)(A) of the Code.

The new 10 percent of value limitation for purposes of defining qualified rents is effective for taxable years beginning after December 31, 2000. There is an exception for rents paid under a lease or pursuant to a binding contract in effect on July 12, 1999 and at all times thereafter.

2. Modify estimated tax rules for closely held REITs (sec. 271 of the bill and sec. 6655 of the Code)

PRESENT LAW

If a person has a direct interest or a partnership interest in income-producing assets (such as securities generally, or mortgages) that produce income throughout the year, that person's estimated tax payments must reflect the quarterly amounts expected from the asset.

However, a dividend distribution of earnings from a REIT is considered for estimated tax purposes when the dividend is paid. Some corporations have established closely held REITs that hold property (e.g., mortgages) that if held directly by the controlling entity would produce income throughout the year. The REIT may make a single distribution for the year, timed such that if need not be taken into account under the estimated tax rules as early as would be the case if the assets were directly held by the controlling entity. The controlling entity thus defers the payment of estimated taxes.

REASONS FOR CHANGE

The Committee is concerned that REITs may be used to defer estimated taxes. Income producing property might be acquired in or transferred to a REIT, and a dividend paid from the REIT only at the end of the year. So long as the dividend is paid by year end (or within a certain period after year end), the REIT pays no tax on the dividend, while the shareholder of the REIT does not include the payment in income until the dividend is paid. Thus, the income from the assets is not counted in the earlier quarters of the year, for purposes of the shareholder's estimated tax.

The Committee is concerned that this type of situation is most likely to occur in cases where the REIT is relatively closely held and may be used to structure payments for the benefit of significant shareholders. In such situations, the Committee believes that persons who are significant shareholders in the REIT should be able to obtain sufficient information regarding the quarterly income of the REIT to determine their share of that income for estimated tax purposes.

EXPLANATION OF PROVISION

In the case of a REIT that is closely held, any person owning at least 10 percent of the vote or value of the REIT is required to accelerate the recognition of year-end dividends attributable to the closely held REIT, for purposes of such person's estimated tax payments. A closely held REIT is defined as one in which at least 50 percent of the vote or value is owned by five or fewer persons. Attribution rules apply to determine ownership.

No inference is intended regarding the treatment of any transaction prior to the effective date.

EFFECTIVE DATE

The provision is effective for estimated tax payments due on or after November 16, 1999.

3. Modify treatment of closely held REITs (sec. 281 of the bill and sec. 856 of the Code).

PRESENT LAW

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives pass-through treatment for income that is distributed to shareholders. If an electing entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to tax at the REIT level.

A REIT must satisfy a number of tests on a year-by-year basis that relate to the entity's: (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income.

Under the organizational structure test, except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons. Generally, no more than 50 percent of the value of the REIT's stock can be owned by five or fewer individuals during the last half of the taxable year. Certain attribution rules apply in making this determination. No similar rule applies to corporate ownership of a REIT. Certain transactions have been structured to attempt to achieve special tax benefits for an entity that controls a REIT.

REASONS FOR CHANGE

The Committee is aware of a number of situations in which a closely held REIT may be used as a conduit to recharacterize items of income. Some cases causing concern have already been addressed by legislation (e.g., "liquidating reits," which attempted to eliminate tax on income for a period of years) or by regulations (e.g., "step-down preferred" stock, which attempted to provide a corporate borrower with a deduction for payment of principal as well as interest on a loan).

Despite these actions, the Committee is concerned that closely-held REITs may still be used to obtain other tax benefits, chiefly from the ability to recharacterize the income earned by the REIT as a dividend to the REIT owners, as well as to control the timing of such a dividend. Therefore, the provision adds new ownership restrictions designed to limit opportunities for inappropriate income recharacterization.

In certain limited cases, the Committee believes that additional time to satisfy the new requirements should be granted to enable the REIT to establish an operating history before bringing the REIT public. The Committee believes that, in addition to other indicia, evidence of significant and steady growth of the REIT is an important component in demonstrating an intent to bring the REIT public.

EXPLANATION OF PROVISION

The provision imposes as an additional requirement for REIT qualification that, except for the first taxable year for which an entity elects to be a REIT, no one person can own stock of a REIT possessing 50 percent or more of the combined voting power of all classes of voting stock or 50 percent or more of the total value of shares of all classes of stock of the REIT. For purposes of determining a person's stock ownership, rules similar to attribution rules for REIT independent contractor qualification under present law apply (secs. 856(d)(5) and 856(h)(3)). However, once stock is deemed owned by a qualified entity (a REIT or a partnership of which a REIT is at least a 50 percent partner) it will not be reattributed under section 318(a)(3)(C). The provision does not apply to ownership by a REIT of 50 percent or more of the stock (vote or value) of another REIT.

An exception applies for a limited period to certain "incubator REITs". An incubator REIT is a corporation that elects to be treated as an incubator REIT and that meets all the following other requirements: (1) it has only voting common stock outstanding, (2) not more than 50 percent of the corporation's real estate assets consist of mortgages, (3) from not later than the beginning of the last half of the second taxable year, at least 10 percent of the corporation's capital is provided by lenders or equity investors who are unrelated to the corporation's largest shareholder, (4) the directors of the corporation must adopt a resolution setting forth an intent to engage in a going public transaction, (5) no predecessor entity (including any entity from which the electing incubator REIT acquired assets in a transaction in which gain or loss was not recognized in whole or in part) had elected incubator REIT status, and (6) the corporation must annually increase the value of real estate assets by at least 10 percent.

For purposes of determining whether a corporation has met the requirement that it annually increase the value of its real estate assets by 10 percent, the following rules shall apply. First, values shall be based on cost and properly capitalizable expenditures with no adjustment for depreciation. Second, the test shall be applied by comparing the value of assets at the end of the first taxable year with those at the end of the second taxable year and by similar successive taxable year comparisons during the eligibility period. Third, if a corporation fails the 10 percent comparison test for one taxable year, it may remedy the failure by increasing the value of real estate assets by 25 percent in the following taxable year, provided it meets all the other eligibility period requirements in that following taxable year.

The new ownership requirement does not apply to an electing incubator REIT until the end of the REIT's third taxable year; and can be extended for an additional two taxable years if the REIT so elects. However, a REIT cannot elect the additional two year extension unless the REIT agrees that if it does not engage in a going public transaction by the end of the extended eligibility period, it shall pay Federal income taxes for the two years of the extended period as if it had not made an incubator REIT election and had ceased to qualify as a REIT for those two taxable years. In such case, the corporation shall file appropriate amended returns within 3 months of the close of the extended eligibility period. Interest would be payable, but no substantial underpayment penalties would apply except in cases where there is a finding that incubator REIT status was elected for a principal purpose other than as part of a reasonable plan to engage in a going public transaction. Notification of shareholders and any other person whose tax position would reasonably be expected to be affected is also required.

If an electing incubator REIT does not elect to extend its initial 2-year extended eligibility period and has not engaged in a going public transaction by the end of such period, it must satisfy the new control requirements as of the beginning of its fourth taxable year (i.e., immediately after the close of the last taxable year of the two-year initial extension period) or it will be required to notify its shareholders and other persons that may be affected by its tax status, and pay Federal income tax as a corporation that has ceased to qualify as a REIT at that time.

If the Secretary of the Treasury determines that an incubator REIT election was filed for a principal purpose other than as part of a reasonable plan to undertake a going public transaction, an excise tax of $20,000 is imposed on each of the corporation's directors for each taxable year for which the election was in effect.

A going public transaction is defined as either (1) a public offering of shares of stock of the incubator REIT, (2) a transaction, or series of transactions, that result in the incubator REIT stock being regularly traded on an established securities market (as defined in section 897) and being held by shareholders unrelated to persons who held such stock before it began to be so regularly traded, or (3) any transaction resulting in ownership of the REIT by 200 or more persons (excluding the largest single shareholder) who in the aggregate own least 50 percent of the stock of the REIT. Attribution rules apply in determining ownership of stock. The requirement that an incubator REIT have only common stock outstanding shall not fail to be met for a taxable year merely because during that year a going public transaction is accomplished through a transaction described in section 368(a)(1), with another entity that had another class of stock outstanding prior to the transaction.

### EFFECTIVE DATE

The provision is effective for taxable years ending after July 14, 1999. Any entity that elects (or has elected) REIT status for a taxable year including July 14, 1999, and which is both a controlled entity and has significant business assets or activities on such date, will not be subject to the proposal. Under this rule, a controlled entity with significant business assets or activities on July 14, 1999, can be grandfathered even if it makes its first REIT election after that date with its return for the taxable year including that date.

For purposes of the transition rules, the significant business assets or activities in place on July 14, 1999, must be real estate assets and activities of a type that would be qualified real estate assets under section 856 of the Code and would produce qualified real estate related income for a REIT.

## TITLE III. EXCLUSION FROM PAYGO SCORECARD

### A. Exclusion from Paygo Scorecard (sec. 301 of the bill)

#### PRESENT LAW

Under the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, tax reduction legislation is subject to a "pay-as-you-go" (PAYGO) requirement. The PAYGO system tracks legislation that may increase budget deficits using a "scorecard" (estimated by the Office of Management and Budget).

#### REASONS FOR CHANGE

The Committee believes that an exclusion from the paygo scorecard is appropriate for the bill.

#### EXPLANATION OF PROVISION

The provision provides that any net deficit increase or net surplus increase resulting from the enactment of the Act is not counted for purposes of section 252 of the Balanced Budget and Emergency Deficit Control Act of 1985.

#### EFFECTIVE DATE

The provision is effective upon enactment.

## 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 provisions of the bill as reported.

The bill, as reported, is estimated to have the following budget effects for fiscal years 1999–2009.

## ESTIMATED BUDGET EFFECTS OF THE "TAX RELIEF EXTENSION ACT OF 1999," AS REPORTED BY THE SENATE COMMITTEE ON FINANCE

[Fiscal years 2000–2009, in millions of dollars]

| Provision | Effective | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2000–2004 | 2000–2009 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Extension of Expiring Provisions Through 12/31/00** | | | | | | | | | | | | | |
| A. Treatment of Nonrefundable Personal Credits Under the Alternative Individual Minimum Tax. | tybi 1999 & 2000 | −972 | −742 | .......... | .......... | .......... | .......... | .......... | .......... | .......... | .......... | −1,714 | −1,714 |
| B. Employer Provided Educational Assistance for Graduate and Undergraduate Courses. | [1] | −254 | −137 | .......... | .......... | .......... | .......... | .......... | .......... | .......... | .......... | −391 | −391 |
| C. Research Tax Credit, and Increase AIC Rates by 1 Percentage Point; Expand to Puerto Rico. | [2] | −1,659 | −942 | −445 | −322 | −185 | −43 | .......... | .......... | .......... | .......... | −3,551 | −3,594 |
| D. Exception from Subpart F for Active Financing Income .............. | tybi 2000 | −187 | −579 | .......... | .......... | .......... | .......... | .......... | .......... | .......... | .......... | −766 | −766 |
| E. Suspension of 100% Net Income Limitation for Marginal Properties. | tyba 12/31/99 | −23 | −12 | .......... | .......... | .......... | .......... | .......... | .......... | .......... | .......... | −35 | −35 |
| F. Work Opportunity Tax Credit .......... | wpoifibwa 6/30/99 | −229 | −217 | −121 | −48 | −17 | −3 | .......... | .......... | .......... | .......... | −632 | −635 |
| G. Welfare-to-Work Tax Credit .......... | wpoifibwa 6/30/99 | −49 | −56 | −37 | −16 | −6 | −1 | [3] | .......... | .......... | .......... | −163 | −165 |
| H. Extend Tax Credit for Electricity Produced from Wind and Closed-Loop Biomass Facilities and Modify to Include Electricity Produced from Poultry Waste and Operators of Such Government Owned Facilities, Landfill Gas Used to Produce Electricity, and Other Biomass (including production from such biomass at coal cofiring facilities). | [4] | −33 | −44 | −46 | −47 | −48 | −49 | −50 | −51 | −53 | −53 | −215 | −473 |
| I. Brownfields Environmental Remediation; Expand to all of the United States. | eia 12/31/99 | −19 | −19 | −5 | [3] | [5] | 1 | 2 | 2 | 3 | 5 | −42 | −29 |
| J. Increased Amount of Rum Excise Tax That is Covered Over to Puerto Rico and the U.S. Virgin Islands (from $10.50 per proof gallon to $13.50 per proof gallon) and Transfer 50 cents to Puerto Rico Conservation Trust [6]. | [7] | −83 | −16 | .......... | .......... | .......... | .......... | .......... | .......... | .......... | .......... | −99 | −99 |
| K. Delay the Requirement that Registered Motor Fuels Terminals Offer Dyed Kerosene as a Condition of Registration. | DOE | | | | | | Negligible Revenue Effect | | | | | | |
| L. Extend Section 29 Placed-in-Service Date (for 8 months) [8] ........ | DOE | .......... | .......... | .......... | .......... | .......... | −438 | −74 | −75 | −27 | .......... | .......... | −613 |
| Total of Extension of Expiring Provisions Through 12/31/00 ....... | .......... | −3,508 | −2,764 | −654 | −433 | −256 | −533 | −122 | −124 | −77 | −48 | −7,608 | −8,514 |

ESTIMATED BUDGET EFFECTS OF THE ''TAX RELIEF EXTENSION ACT OF 1999,'' AS REPORTED BY THE SENATE COMMITTEE ON FINANCE—Continued

[Fiscal years 2000–2009, in millions of dollars]

| Provision | Effective | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2000–2004 | 2000–2009 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **II. Revenue Offset Provisions** | | | | | | | | | | | | | |
| A. Modify Individual Estimated Tax Safe Harbor to 110.5% for tax year 2000, and 112% for tax year 2004. | tyba 12/31/99 | 2,700 | −2,700 | ............... | ............... | 1,200 | −1,200 | ............... | ............... | ............... | ............... | 1,200 | ................ |
| B. Modify Foreign Tax Credit Carryover Rules—1-year carryback of foreign tax credits and 7-year carryforward. | tyba 12/31/99 | 87 | 562 | 502 | 468 | 437 | 406 | 279 | 263 | 259 | 257 | 2,056 | 3,520 |
| C. Clarify the Tax Treatment of Income and Losses from Derivatives. | DOE | (5) | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 4 | 9 |
| D. Add the Streptococcus Pneumoniae Vaccine to the List of Taxable Vaccines in the Federal Vaccine Insurance Program; Study of Program. | (9) | 4 | 7 | 9 | 10 | 10 | 10 | 10 | 10 | 10 | 11 | 39 | 91 |
| E. Information Reporting on Cancellation of Indebtedness by Non-Bank Financial Institutions. | coia 12/31/99 | ............... | 7 | 7 | 7 | 7 | 7 | 7 | 7 | 7 | 7 | 28 | 63 |
| F. Impose Limitation on Pre-Funding of Certain Employee Benefits | cpoaa 6/9/99 | 115 | 141 | 147 | 149 | 140 | 129 | 118 | 105 | 90 | 74 | 693 | 1,209 |
| G. Increase to 15% (from 10%) Optional Withholding Rate for Nonperiodic Payments from Deferred Compensation Plan. | dma /12/31/00 | ............... | 52 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 55 | 59 |
| H. Prevent the Conversion of Ordinary Income or Short-Term Capital Gains into Income Eligible for Long-term Capital Gain Rates. | teio/a /7/12/99 | 15 | 45 | 47 | 49 | 51 | 54 | 58 | 62 | 66 | 70 | 207 | 517 |
| I. Allow Employers to Transfer Excess Defined Benefit Plan Assets to a Special Account for Health Benefits of retirees (through 9/30/99). | tmi tyba 12/31/00 | ............... | 19 | 38 | 39 | 40 | 41 | 42 | 42 | 43 | 44 | 136 | 348 |
| J. Repeal Installment Method for Most Accrual Basis Taxpayers; Adjust Pledge Rules. | iso/a DOE | 477 | 677 | 406 | 257 | 72 | 8 | 21 | 35 | 48 | 62 | 1,889 | 2,063 |
| K. Limit Use of Non-Accrual Experience Method of Accounting to Amounts to be Received for the Performance of Qualified Professional Services. | tyea DOE | 77 | 60 | 33 | 28 | 10 | 12 | 14 | 16 | 18 | 20 | 208 | 288 |
| L. Deny Deduction and Impose Excise Tax With Respect to Charitable Split-Dollar Life Insurance Arrangements. | (10) | Negligible Revenue Effect | | | | | | | | | | | |
| M. Prevent Duplication of Loss Through Assumption of Certain Liabilities. | aolo/a 10/19/99 | (5) | 7 | 8 | 10 | 11 | 12 | 14 | 15 | 16 | 17 | 36 | 110 |
| N. Require Consistent Treatment and Provide Basis Allocation Rules for Transfers of Intangibles in Certain Nonrecognition Transactions. | to/a DOE | 25 | 26 | 28 | 29 | 30 | 32 | 34 | 35 | 37 | 39 | 138 | 315 |
| O. Distributions by a Partnership to a Corporate Partner of Stock in Another Corporation. | (11) | 4 | 9 | 10 | 10 | 9 | 9 | 9 | 9 | 9 | 8 | 42 | 86 |

| | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| P. Prohibited Allocation of Stock in an ESOP of a Subchapter S Corporation. | ([12]) | 2 | 4 | 5 | 6 | 8 | 8 | 9 | 10 | 10 | 10 | 26 | 74 |
| Q. Real Estate Investment Trust (REIT) Provisions: | | | | | | | | | | | | | |
| 1. Impose 10% vote or value test | tyba 12/31/00 | ............... | 2 | 8 | 8 | 8 | 9 | 9 | 9 | 10 | 10 | 26 | 73 |
| 2. Treatment of income and services provided by taxable REIT subsidiaries, with 20% asset limitation. | tyba 12/31/00 | ............... | 50 | 131 | 44 | 19 | −9 | −39 | −72 | −107 | −146 | 244 | −129 |
| 3. Personal property treatment for determining rents from real property for REITs. | tyba 12/31/00 | −1 | −1 | −1 | −1 | −1 | −1 | −1 | −1 | −1 | −1 | −3 | −7 |
| 4. Special foreclosure rule for health care REITs | tyba 12/31/00 | | | | | | Negligible Revenue Effect | | | | | | |
| 5. Conformity with RIC 90% distribution rules | tyba 12/31/00 | ............... | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 3 | 5 |
| 6. Clarification of definition of independent operators for REITs | tyba 12/31/00 | | | | | | Negligible Revenue Effect | | | | | | |
| 7. Modification of earnings and profits rules | da 12/31/00 | ............... | −6 | −3 | −3 | −3 | −4 | −4 | −4 | −4 | 4 | −16 | −35 |
| 8. Modify estimated tax rules for closely-owned REIT dividends | epdo/a 11/15/99 | 40 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 45 | 52 |
| 9. Modify treatment of closely-held REITs, with incubator REIT exception; grandfather REIT transaction in progress. | tyea 7/14/99 | 2 | 5 | 5 | 5 | 6 | 6 | 6 | 6 | 7 | 7 | 23 | 55 |
| Subtotal of Revenue Offset Provisions | | 3,548 | −1,031 | 1,384 | 1,119 | 2,058 | −467 | 590 | 551 | 522 | 489 | 7,079 | 8,766 |
| Total | | 40 | −3,795 | 730 | 686 | 1,802 | −1,000 | 468 | 427 | 445 | 441 | −529 | 252 |
| **III. Application of PAYGO Surplus From Previously Enacted Legislation** | | ............... | 529 | ............... | ............... | ............... | ............... | ............... | ............... | ............... | ............... | 529 | ............... |
| Net Total | | 40 | −3,266 | 730 | 686 | 1,802 | −1,000 | 468 | 427 | 445 | 441 | ............... | 252 |

[1] Effective for graduate courses beginning after 12/31/99 under undergraduate courses beginning after 5/31/00.

[2] Extension of credit effective for expenditures paid or incurred beginning after 6/30/99; increase in A/C rates effective for taxable years beginning after 6/30/99; expansion of the credit to include U.S. possessions effective for expenditures paid or incurred beginning after 6/30/99.

[3] Loss of less than $500,000.

[4] For wind, provision applies to production from facilities placed in service after 6/30/99 and before 1/1/01; for poultry waste, and landfill gas, provision applies to production from facilities placed in service after 12/31/99 and before 1/1/01; for closed-loop and other biomass, provision applies to electricity produced after 12/31/99 from facilities that are placed in service before 1/1/01.

[5] Gain of less than $500,000.

[6] Estimate provided by the Congressional Budget Office.

[7] Effective for rum imported into the United States before 6/30/99.

[8] Binding contract date of 1/1/97 and production deadline of 1/1/08 assumed to be unchanged. Credit cannot be claimed until after 9/30/04.

[9] Effective for vaccine sales the date after the date on which the Centers for Disease Control make final recommendation for routine administration of conjugate Streptococcus Pneumoniae vaccines to children.

[10] Effective for transfers made after 2/8/99 and for premiums paid after the date of enactment.

[11] Effective 7/14/99 (except with respect to partnerships in existence on 7/14/99, the provision in effect on the date of enactment).

[12] Generally effective with respect to years beginning after December 31, 2000. In the case of an ESOP established after July 14, 1999, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the proposal would be effective with respect to plan years ending after July 14, 1999.

Legend for "Effective" column: aolo/a = assumption of liabilities on or after; coia = cancellation of indebtedness after; cpoaa = contributions paid or accrued after; da = distributions after, dma = distributions made after; DOE = date of enactment; eia = expenses incurred after; epdo/a = estimated payments due on or after; iso/a = installment sales on or after; teio/a = transactions entered into on or after; to/a = transactions on or after; tmi = transfers made in; tyba = taxable years beginning after; tyea = taxable years ending after; tybi = taxable years beginning in; and wpoifibwa = wages paid or incurred for individuals beginning work after.

Note.—Details may not add to totals due to rounding.

Source: Joint Committee on Taxation.

### B. Budget Authority and Tax Expenditures

*Budget authority*

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the provisions of the bill as reported involved no new or increased budget authority.

*Tax expenditures*

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the extensions of expiring income tax provisions involve increased tax expenditures, and that certain revenue offset provisions (other than the foreign tax credit provisions) involve reduced tax expenditures (see revenue table in Part III.A, above).

### C. Consultation with the Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget office has not submitted a statement on this bill.

## IV. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of Rule XXVI of the Standing Rules of the Senate, the following statements are made concerning the rollcall votes in the Committee's consideration of the bill.

*Motion to report the bill*

The bill was ordered favorably reported by a unanimous voice vote on October 20, 1999. A quorum was present. No amendments were voted upon.

## 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 bill provides extensions of certain expired or expiring tax provisions: (1) extend minimum tax relief for individuals; (2) extend exclusion for employer-provided educational assistance; (3) extend research and experimentation credit and increase in the rates for the alternative incremental research credit; (4) extend exceptions under subpart F for active financing income; (5) extend suspension of net income limitation on percentage depletion from marginal oil and gas wells; (6) extend the work opportunity tax credit; (7) extend the welfare-to-work tax credit; (8) extend and modify tax credit for electricity produced by wind and closed-loop biomass facilities; (9) expand brownfields environmental remediation; (10) temporary increase in amount of rum excise tax that is covered over to Puerto Rico and the U.S. Virgin Islands; (11) delay requirement that registered motor fuels terminals offer dyed fuel as a condition of registration; and (12) production credit for fuel produced by certain coal gasification facilities.

Title II of the bill provides certain revenue-offset provisions: (1) modification of individual estimated tax safe harbor; (2) modify foreign tax credit carryover rules; (3) clarify the tax treatment of income and losses on derivatives; (4) add certain vaccines against Streptococcus Pneumoniae to the list of taxable vaccines; (5) expand reporting of cancellation of indebtedness income; (6) impose limitation on prefunding of certain employee benefits; (7) increase elective withholding rate for nonperiodic distributions from deferred compensation plans; (8) limit conversion of character of income from constructive ownership transactions; (9) treatment of excess pension assets used for retiree health benefits; (10) modify installment method and prohibit its use by accrual method taxpayers; (11) limitation on use of nonaccrual experience method of accounting; (12) denial of charitable contribution deduction for transfers associated with split-dollar insurance arrangements; (13) prevent duplication or acceleration of loss through assumption of certain liabilities; (14) require consistent treatment and provide basis allocation rules for transfers of intangibles in certain nonrecognition transactions; (15) distributions by a partnership to a corporate partner of stock in another corporation; (16) prohibited allocations of stock in an S corporation ESOP; (17) provisions relating to REITs; (18) modify treatment of closely held REITs; and (19) modify estimated tax rules for closely held REITs.

Title III provides for an exclusion from the paygo scorecard.

The revenue-offset provisions will increase the tax burden on the affected taxpayers. The extensions of expired and expiring provisions generally will reduce the tax burdens on individuals, small businesses, and others.

*Impact on personal privacy and paperwork*

The bill should not have any adverse impact on personal privacy. Additional paperwork may be required by the changes in the estimated tax safe harbor for individuals, the estimated tax rules for REITs, and the expanded reporting of cancellation of indebtness income.

### B. Unfunded Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates 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: (1) clarify the tax treatment of income and losses on derivatives; (2) add certain vaccines against Streptococcus Pneumoniae to the list of taxable vaccines; (3) expand reporting of cancellation of indebtedness income; (4) impose limitation on prefunding of certain employee benefits; (5) limit conversion of character of income from constructive ownership transactions; (6) modify installment method and prohibit its use by accrual method taxpayers; (7) limitation on use of nonaccrual experience method of accounting; (8) denial of charitable contribution deduction for transfers associated with split-dollar insurance arrangements; (9) prevent duplication or acceleration of loss through assumption of certain liabilities; (10) require consistent treatment and provide basis allocation rules for transfers of intangibles in certain nonrecognition transactions; (11) distributions by a partnership to a corporate partner of stock in another corporation; (12) prohibited allocations of stock in an S corporation ESOP; (13) impose 10 percent vote or value test for REITs; (14) treatment of income and services provided by taxable REIT subsidiaries, with 20 percent asset limitation; (15) modify treatment of closely held REITs; and (16) modify estimated tax rules for closely held REITs.

The costs required to comply with each Federal private sector mandate generally are no greater than the estimated budget effect of the provision. Benefits from the provisions include improved administration of the Federal tax laws and a more accurate measurement of income for Federal income tax purposes.

The provision that adds Streptococcus Pneumoniae vaccine to the list of taxable vaccines for purposes of the vaccine excise tax imposes a Federal intergovernmental mandate on State, local, and tribal governments. The staff of the Joint Committee on Taxation estimates that the direct costs of complying with this Federal intergovernmental mandate 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. The Committee intends that this Federal intergovernmental mandate be unfunded because the net revenues from the Federal vaccine excise tax are used to finance the Federal Vaccine Injury Compensation Trust Fund. Because the excise tax is imposed on the private sector and on State, local, and tribal governments, it does not affect the competitive balance between such governments and the private sector.

### C. Complexity Analysis

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the House Committee on Ways and Means, the Senate Committee on Finance, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Internal Revenue Code and that have widespread applicability to individuals or small businesses.

## 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).